

PUNITIVE DAMAGES ARE A NECESSARY REMEDY IN BROKER-CUSTOMER SECURITIES ARBITRATION CASES

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INTRODUCTION

The two primary legal doctrines in this Article, punitive damages and securities arbitration, each have produced highly publicized close decisions resulting in inconsistent and contentious litigation. The issues raised by this litigation were joined in the case *Mastrobuono v. Shearson Lehman Hutton, Inc.*,¹ recently decided by the United States Supreme Court. *Mastrobuono's* result has enormous financial implications for securities firms and their customers, as well as other industries which arbitrate their disputes.

Securities firms typically require investors to sign a predispute arbitration agreement (PDAA), drafted by their brokers, as a condition to investing. When a dispute arises, it is settled in accordance with previously elected rules, and usually the arbitrator may grant any remedy or relief deemed just and equitable. (Translation: compensatory damages and attorney's fees are available, as are punitive damages, if warranted.) Punitive damages awarded by arbitrators have become a highly publicized lightning rod of sorts, partly due to their perceived frequency and magnitude. The securities industry charges that when arbitration agreements are governed by the law of a state prohibiting punitive damages, state law should control, despite strong federal policy supporting arbitration of all arbitrable claims. Investors, on the other hand, consider punitive damages in arbitration appropriate since punitive damages would frequently have been an available remedy had the case been litigated in court.

This Article addresses important and recurring questions regarding the availability of punitive damages awards in securities arbitrations and, to a lesser extent, other arbitrations. This controversial issue has spawned a mass of conflicting decisions, by both state and circuit courts, and most recently by the Supreme Court. Primarily, the Court in *Mastrobuono* considered whether arbitrators of securities fraud disputes possess the power, pursuant to the Federal Arbitration Act, to award punitive damages—even when state law prohibits such awards. As a related issue, the Court questioned whether customers who must sign a PDAA to open a brokerage account waive the right to recover punitive damages where the agreement is governed by the law of a state prohibiting the awards. The resolution of these issues depends, in part, on which view of the government's power one adopts. An expansive view of federal powers recognizes the ability of arbitrators to award punitive damages, while a restrictive view upholds state laws and allows awards of only compensatory damages.

This Article contains four main sections. Part I outlines the history and evolution of the Federal Arbitration Act (FAA) and discusses the Act's power relative to state law.

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1. 115 S. Ct. 1212 (1995).

Part II addresses the constitutionality of punitive damages, their use in arbitral forums, and relevant state laws. Part III analyzes the phenomenon of punitive damages in securities arbitrations. Finally, Part IV discusses the inconsistencies which still must be resolved.

I. THE LAW OF ARBITRATION

A. *History of Arbitration: The Federal Arbitration Act (FAA)*

Arbitration becomes an issue when parties to a transaction or contract include a written provision agreeing to settle any controversy arising therefrom by arbitration. This dispute resolution technique is only one of many alternatives to traditional litigation in a judicial forum. Congress enacted the FAA in 1925 in an effort to encourage the use of arbitration as a means to resolve commercial disputes instead of litigating such matters. The FAA's main objective is "to effect expeditious and economical solution of disputes."² The law is designed "to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate,"³ and thus ensures that such agreements are recognized as "valid, irrevocable, and enforceable."⁴ Courts must therefore abide by the parties' agreement and are bound by arbitrators' decisions, barring evidence of misconduct, such as fraud or corruption.⁵

The United States Supreme Court has taken many opportunities to consider arbitration cases, and one of the most recognizable themes is the Court's commitment to support and enforce the FAA. Justice O'Connor's opinion in *Shearson/American Express, Inc. v. McMahon* begins with these words:

The Federal Arbitration Act . . . provides the starting point for answering the questions raised in this case. The Act was intended to "revers[e] centuries of judicial hostility to arbitration agreements," by "plac[ing] arbitration agreements 'upon the same footing as other contracts.'" The Arbitration Act accomplishes this purpose by providing that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or

2. 9 U.S.C. §§ 1-16 (1994). See Joseph P. Lakatos & Thomas G. Stenson, *Punitive Damages Under the Federal Arbitration Act: Have Arbitrators' Remedial Powers Been Circumscribed by State Law?*, 7 J. LEGAL COMM. 661, 662-64 (1992); Carolyn Grace & Gretchen Van Ness, *A Road Not Taken: Reconsidering Mandatory Arbitration of Securities Disputes*, BOSTON B.J., Jan.-Feb. 1992, at 24, 24 (the FAA was enacted to curb hostility towards arbitration agreements, which courts considered revocable at any time prior to an award being made). See also *Baker v. Sadick*, 208 Cal. Rptr. 676, 682 (1985).

3. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219-20 (1985) (per curiam). See also Anthony M. Sabino, *Awarding Punitive Damages in Securities Industry Arbitration: Working for a Just Result*, 27 U. RICH. L. REV. 33, 34-38 (1992). See generally *Garrity v. Lyle Stuart, Inc.*, 353 N.E. 2d 793 (N.Y. 1976) (4-3 decision) (majority suspicious of arbitrators' powers and unwilling to acknowledge their professionalism).

4. 9 U.S.C. § 2 (1994). This section is perhaps the cornerstone of the FAA, in that it unequivocally declares such agreements valid ("save upon such grounds as exist at law or in equity for the revocation of any contract"). *Id.* See generally H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924) (The report accompanying FAA makes clear that arbitration agreements are to be construed as equals to other contracts.).

5. 9 U.S.C. § 10 (1994). See C. Evan Stewart, *Securities Arbitration Appeal: An Oxymoron No Longer?*, 79 KY. L.J. 347 (1990-91).

in equity for the revocation of any contract.” The Act also provides that a court must stay its proceedings if it is satisfied that an issue before it is arbitrable under the agreement . . . and it authorizes a federal district court to issue an order compelling arbitration if there has been a “failure, neglect, or refusal” to comply with the arbitration agreement⁶

The Court’s support for arbitration is further evident in *Dean Witter Reynolds, Inc. v. Byrd*, where the Court wrote that the “preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate”⁷ Attempting to combat the historical suspicion and hostility towards arbitration, the Court in *Scherk v. Alberto - Culver Co.* upheld the arbitration clause to an international contract, declaring that it had the same force and effect as other contracts.⁸

As to the scope of the parties’ agreement to arbitrate, the Court in *Mitsubishi Motors Corp. v. Soler Chrysler - Plymouth, Inc.* considered the scope of an arbitration clause concerning complex antitrust issues.⁹ Concluding that these claims were arbitrable, the Court required the American company “to honor its bargain.”¹⁰ The Court noted that “as with any other contract, the parties’ intentions control, but those intentions are generously construed as to issues of arbitrability.”¹¹ This expansive reading is perhaps most pronounced in *Moses H. Cone Memorial Hospital v. Mercury Construction Co.*¹² Finding the contractual dispute in *Cone* arbitrable as per the parties’ agreement, the Court set forth a rule of liberal construction:¹³ “Section 2 [of the FAA] is a congressional declaration of a liberal federal policy favoring arbitration agreements The effect . . . is to create a body of federal substantive law of arbitrability . . . [and requires that any questions] be addressed with a healthy regard for the federal policy favoring arbitration.”¹⁴ *Cone* established the principle that the FAA created federal substantive law.

This general background is particularly helpful when considering the following cases construing the FAA when there are potentially conflicting state laws. By passing the FAA, a body of federal substantive law was created, yet no federal question jurisdiction was established. Therefore, federal courts have jurisdiction only if diversity of citizenship or another independent basis for federal jurisdiction exists.¹⁵ Recognizing this

6. 482 U.S. 220, 225-26 (1987) (citations omitted).

7. 470 U.S. at 221.

8. 417 U.S. 506, 510-11 (1974).

9. 473 U.S. 614 (1985). The claims involved the Sherman Act, in which some remedies provisions are punitive in nature. *Id.* at 636-37. See 15 U.S.C. §§ 1-6201 (1994).

10. *Mitsubishi*, 473 U.S. at 640.

11. *Id.* at 626.

12. 460 U.S. 1 (1983).

13. *Id.* at 24; cf. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 476 (1989).

14. *Cone*, 460 U.S. at 24. See generally *Perry v. Thomas*, 482 U.S. 483, 490-93 (1987) (holding that due regard must be given to federal policy in applying state law principles to construction of contracts that contain arbitration clauses); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405-06 (1967).

15. See *Cone*, 460 U.S. at 25 n.32. If diversity of citizenship is the basis for federal court jurisdiction, then *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), comes into play.

jurisdictional problem, the Court in *Southland Corp. v. Keating* considered a state law that invalidated certain agreements covered by the FAA.¹⁶ The Court first found that the FAA “rests on the authority of Congress to enact substantive rules under the Commerce Clause.”¹⁷ It then flatly concluded that the state franchise law was preempted, pursuant to the Supremacy Clause, where it rendered agreements to arbitrate certain claims unenforceable.¹⁸

Southland Corp. v. Keating firmly establishes the supremacy of the federal substantive law of arbitrability.¹⁹ Therefore, the FAA’s substantive provisions are applicable in state as well as federal court.

The three arbitration cases discussed next focus on this tension between federal and state laws of arbitration. The unsettled nature of arbitration is partly because the “FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration.”²⁰ Thus, since Congress has not totally displaced state regulation of arbitration, federal courts must attempt to reconcile both sets of laws, and “state law may nonetheless be pre-empted to the extent that it actually conflicts with federal law.”²¹ In construing state and federal arbitration laws, the Supreme Court in *Bernhardt v. Polygraphic Co.* upheld the application of state law regarding an arbitration provision in a contract, concluding that the agreement was not covered by the federal arbitration law.²² A state law again was challenged by application of the FAA in *Perry v. Thomas*.²³ The Supreme Court concluded that the state law, which required that “litigants be provided a judicial forum for resolving wage disputes,” was preempted.²⁴ It reasoned that the clear federal policy favoring arbitration supersedes the conflicting state-created right.²⁵

The most important case construing state law in light of the FAA mandate is *Volt Information Sciences, Inc. v. Board of Trustees*.²⁶ Volt, when a dispute developed, made a formal demand for arbitration, as per the parties’ agreement under section 4 of the FAA.²⁷ In state court, the Board of Trustees of Leland Stanford Junior University

16. 465 U.S. 1 (1984).

17. *Id.* at 11. The state law was invalidated pursuant to the Supremacy Clause. *Id.* at 16.

18. *Id.* at 10.

19. *Id.* at 11. *But see id.* at 25-28 (O’Connor, J., dissenting) (legislative history conclusively establishes the FAA as procedural) and *id.* at 17-19 (Stevens, J., concurring in part and dissenting in part) (questioning whether Congress intended to entirely “displace state authority”).

20. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477 (1989).

21. *Id.*

22. 350 U.S. 198 (1956).

23. 482 U.S. 483 (1987).

24. *Id.* at 490-91.

25. Again, as in *Keating*, Justices Stevens and O’Connor wrote separately regarding their skepticism of the majority’s reading of the FAA. *Id.* at 493 (Stevens, J., dissenting) (The Supreme Court “has effectively rewritten [the FAA] to give it a pre-emptive scope that Congress certainly did not intend.”); *id.* at 494 (O’Connor, J., dissenting) (state powers to except certain disputes from arbitration should be respected unless Congress decides otherwise.).

26. 489 U.S. 468 (1989).

27. *Id.* at 470.

successfully moved to stay arbitration under authority of state law which allows a stay if "there is a possibility of conflicting rulings on a common issue of law or fact."²⁸ The appeals court affirmed the stay of arbitration,²⁹ as did the Supreme Court.³⁰ Chief Justice Rehnquist wrote that the stay of arbitration, in accordance with the parties' agreement, did not undermine the goals and policies of the FAA.³¹ Reasoning that since the parties were completely free to structure their agreement, whereby they agreed to abide by the state rules, "enforcing those rules . . . is fully consistent with the goals of the FAA, *even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward.*"³²

The Court cautioned that the FAA does not confer a right to compel arbitration of any dispute at any time, but rather it confers the right to seek an order compelling arbitration "in the manner provided for in [the parties'] agreement."³³ Finding no actual conflict with federal law, the Court upheld a choice of law clause even though it displaced *procedural* provisions of the FAA.³⁴ The Court noted however, that the FAA's substantive provisions are applicable in state and federal courts as provided by *Southland Corp. v. Keating*.³⁵

Volt is quite important to the outcome of *Mastrobuono*, where the applicable state law bars punitive damages, yet federal law endorses such awards. How strictly choice of law clauses are to be construed becomes a central issue. If courts, following *Volt*, find that state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," the FAA will preempt such state law.³⁶ Short of this threshold, state law will be enforced in conjunction with the FAA.³⁷ Also, to the extent that the power to award punitive damages is viewed as a substantive rather than a procedural issue, the FAA under the Supremacy and Commerce Clauses preempts conflicting state law.

28. *Id.* at 471. See CAL. CIV. PROC. CODE § 1281.2(c) (West 1982 & Supp. 1995).

29. *Volt*, 489 U.S. at 471.

30. *Id.* at 479. See generally Sabino, *supra* note 3, at 57-60, 62; Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, 587-88 (1991).

31. *Volt*, 489 U.S. at 477-78; *cf.* *Moses H. Cone Memorial Hosp. v. Mercury Constr. Co.*, 460 U.S. 1, 24-25 (1983).

32. *Volt*, 489 U.S. at 479 (emphasis added).

33. *Id.* at 474-75; *cf.* 9 U.S.C. § 4 (1994).

34. *Volt*, 489 U.S. at 476-79. See also Jon R. Schumacher, Note, *The Reach of the Federal Arbitration Act: Implications on State Procedural Law*, 70 N.D. L. REV. 459, 474-76 (1994).

35. *Volt*, 489 U.S. at 477 n.6; see also *Southland Corp. v. Keating*, 465 U.S. 1, 12, 16 n.10, 29 (1984) (O'Connor, J., dissenting).

36. *Volt*, 489 U.S. at 477 (citing *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

37. *Id.*; *cf.* Donald O. Mayer & Ellwood F. Oakley III, *Federalism and the Arbitration of Employment Discrimination Claims*, 26 BUS. L. REV. 39 (1993).

*B. Arbitration as it has Developed in Resolution of Securities Disputes*³⁸

As discussed previously, arbitration has developed over the past seventy years to the point where it is a favored dispute resolution technique. While more clarity is necessary to determine how state arbitration laws interact with the FAA, courts rigorously enforce agreements to arbitrate. The seminal case construing agreements to arbitrate securities disputes is *Shearson/American Express, Inc. v. McMahon*.³⁹ The customers in *McMahon*, alleging that their broker had violated securities laws, filed suit in federal district court.⁴⁰ The defendants moved to compel arbitration pursuant to the PDAA signed by the parties.⁴¹ Notwithstanding the Securities Exchange Act of 1934's provision, which grants jurisdiction for resolving disputes to federal courts,⁴² the Supreme Court upheld the PDAA, and the claim was arbitrated as per the FAA.⁴³ The Court compelled enforcement of the PDAA, concluding that there was "sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights."⁴⁴ Hailed by the securities industry as an economical way to resolve disputes, this decision dramatically altered the arbitration environment.⁴⁵

Just two Terms later, the Court decided *Rodriguez de Quijas v. Shearson/American Express, Inc.*⁴⁶ The Court considered a dispute arising under the Securities Act of 1933,⁴⁷ a companion statute to the one involved in *McMahon*.⁴⁸ Overruling the long-standing precedent of *Wilko v. Swan*,⁴⁹ the *Rodriguez de Quijas* Court upheld the PDAA and mandated arbitration of the Securities Act claims.⁵⁰ The Court reasoned that it needed to harmonize the result with *McMahon*, and that "arbitration . . . does not inherently undermine any . . . substantive rights."⁵¹

38. This subpart addresses arbitration of securities disputes. It includes discussions of cases, how a claim arises, and the impact arbitration has had in securities disputes, as well as its current status.

39. 482 U.S. 220 (1987). See Margo E. K. Reder, *Securities Law and Arbitration: The Enforceability of Pre-dispute Arbitration Clauses in Broker-Customer Agreements*, 1990 COLUM. BUS. L. REV. 91-117.

40. *McMahon*, 482 U.S. at 223.

41. *Id.*

42. Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1994).

43. *McMahon*, 482 U.S. at 238. Furthermore, the Court compelled arbitration of RICO claims. RICO is a statute in which some of the remedies are punitive in nature. *Id.* at 242. See 18 U.S.C. § 1964(c) (1994).

44. *McMahon*, 482 U.S. at 242.

45. See Quinton F. Seamons, *Punitive Damages in Securities Arbitration: Jokers, Deuces, and One-Eyed Jacks are Wild!*, 21 SEC. REG. L.J. 387, 389-92 (1994).

46. 490 U.S. 477 (1989).

47. 15 U.S.C. §§ 77a-77bbbb (1994).

48. *Rodriguez de Quijas*, 490 U.S. at 478-79.

49. 346 U.S. 427 (1953), overruled by *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

50. *Rodriguez de Quijas*, 490 U.S. at 484-86.

51. *Id.* See also *Securities Indus. Ass'n v. Connolly*, 883 F.2d 1114 (1st Cir. 1989), cert. denied, 495 U.S. 956 (1990); see generally Gerald A. Madek, *State Regulation of Broker-Customer Pre-dispute Arbitration Agreements*, 20 N.C. CENT. L.J. 27 (1992); Janet E. Kerr, *The Arbitration of Securities Laws Disputes After Rodriguez and the Impact on Investor Protection*, 73 MARQ. L. REV. 217 (1989).

Unlike customers, who have historically preferred jury trials, the securities industry has encouraged arbitration because "it avoid[s] the risk of jury trials and 'runaway' awards" by sympathetic juries.⁵² As a direct result of the *McMahon* mandate, arbitration claims have risen from less than 3,000 cases before 1987, to approximately 7,000 cases in 1993.⁵³

Currently, it is virtually impossible to enter into a broker-customer relationship without signing an arbitration agreement that is supplied by the broker. By doing so, the customer typically agrees that all disputes arising from the contract will be settled by arbitration in accordance with a certain set of rules.⁵⁴ Many agreements contain a second feature, a choice of law provision, directing that the agreement will be governed by the laws of a certain state.⁵⁵ Such a clause is often used even where the two parties have no significant contacts with that state.⁵⁶ (Not coincidentally, the typical PDAA selects New York law because this jurisdiction prohibits arbitrators from awarding punitive damages in contract cases.⁵⁷)

The requirements in the PDAAs are clear: arbitration is mandated and is a precondition to any judicial review of the dispute. Because arbitration agreements are valid and enforceable,⁵⁸ the FAA directs courts to stay proceedings on arbitrable issues, and alternatively, to order arbitration on such issues if there is a reluctant party.⁵⁹ Arbitrators are empowered to perform many functions similar to a judicial tribunal, and in fact their power is nearly plenary.⁶⁰ Only under very limited circumstances will a challenge to an arbitrator's award succeed.⁶¹

Securities arbitration is "mostly handled by the . . . 10 separate self-regulatory

52. Seamons, *supra* note 45, at 390. See Mark Weibel, *Federal Securities Arbitration: Does it Provide Adequate Relief?*, ARB. J., Mar. 1993, at 54, 57.

53. Daniel McGinn, *Can't Get No Satisfaction*, NEWSWEEK, Aug. 29, 1994, at 41; Richard Karp, *Wall Street's New Nightmare*, BARRON'S, Feb. 21, 1994, at 15.

54. See, e.g., *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 715 (7th Cir. 1994), *rev'd*, 115 S. Ct. 1212 (1995); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 7 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1386 (11th Cir. 1988).

55. See, e.g., *Mastrobuono*, 20 F.3d at 715 (New York law governs); *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976) (New York law governs); *cf. Lee v. Chica*, 983 F.2d 883, 884 (8th Cir. 1993), *cert. denied*, 114 S. Ct. 287 (1993) (Minnesota law governs); *Raytheon*, 882 F.2d at 7 (California law governs).

56. See *Mastrobuono*, 20 F.3d at 715. The plaintiffs were Illinois residents and the broker solicited and serviced their account from Shearson's Houston, Texas office. *Id.*

57. See *Garrity*, 353 N.E.2d at 793. This decision has been repeatedly reaffirmed. See, e.g., *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2nd Cir. 1991); *Stratton Oakmont, Inc. v. Nicholson*, 868 F. Supp. 486 (E.D. N.Y. 1994); Karp, *supra* note 53, at 15-16 (brokerage industry "hoped to export New York's non-punitive damages ruling throughout the U.S."). See generally N.Y. ST. L. DIGEST, March 1995 (No. 423), at 1 (New York is favored state among national brokerage houses as industry finds its industry laws "congenial").

58. 9 U.S.C. § 2 (1994); *cf. Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 338 U.S. 395, 404 n.12 (1967) (arbitration agreements are "as enforceable as other contracts, but not more so").

59. 9 U.S.C. §§ 3, 4 (1994); *cf. Southland Corp. v. Keating*, 465 U.S. 1, 16, 29 (1984).

60. 9 U.S.C. §§ 7, 9, 10 (1994).

61. *Id.* § 10.

organizations" (SROs) of the brokerage business.⁶² The NASD, which is the SRO for the Nasdaq market, has an arbitration department, as does the New York Stock Exchange, and so forth. A non-securities group, the American Arbitration Association (AAA) also resolves securities disputes.⁶³ All SROs are regulated by the Securities and Exchange Commission.

The first feature contained in any PDAA is the set of rules by which disputes are settled. The rules vary slightly among the different SROs, which administer roughly 90% of the cases.⁶⁴ For example, as to the availability of punitive damages, the NASD allows "arbitrators [to] consider punitive damages as a remedy,"⁶⁵ whereas the AAA rule is less explicit, providing that an arbitrator "may grant any remedy or relief which he deems just and equitable." This AAA provision has been recognized by courts as including the power to award punitive damages.⁶⁶

The second feature of PDAAs, not required but often used, is the choice of law provision. This was the paramount issue in *Mastrobuono*, discussed in Part III of this Article. Under this provision, the brokerage firm hopes that by inserting a choice of law clause naming a state that bars punitive damages awards, it will not be liable for such awards, despite arbitration forum rules that may allow this relief.

Just as there has been a sharp rise in claims since arbitration became mandatory, the complexity and cost of claims, and the size of awards have increased.⁶⁷ It has become "Wall Street's new nightmare."⁶⁸ In 1983, damages requested at NASD arbitrations amounted to \$56.9 million. By 1993, the figure had jumped to \$499.6 million.⁶⁹ Punitive damages, historically perceived as unavailable in securities arbitration, have increasingly been awarded, ranging from \$250,000 to \$3.5 million in 1992.⁷⁰ The specter of punitive damages has received widespread attention, even though fewer than two percent of all securities arbitration awards include them.⁷¹

62. Margaret Popper, *Is Arbitration Fair?*, INVESTMENT DEALERS' DIG., Apr. 20, 1992, at 14, 15. Many, of course, take issue with the term "self-regulatory."

63. See Karp, *supra* note 53, at 15; *cf.* Popper, *supra*, note 62, at 15 (AAA handles some broker-customer disputes but typically hears employment disputes between brokers and their firms).

64. Popper, *supra* note 62, at 15. As between all arbitration venues, claimants prevail roughly 60% of the time, receiving about 60% of the amount sought. See also Karp, *supra* note 53, at 16.

65. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 717 (7th Cir. 1994).

66. American Arbitration Association, Commercial Arbitration Rule 42 (now known as Rule 43), available in WESTLAW, AAA-Pubs database, 1993 WL 495832 (A.A.A.). See *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1386-87 (11th Cir. 1988).

67. Karp, *supra* note 53, at 15. See also Seamons, *supra* note 45, at 389-90.

68. Karp, *supra* note 53, at 15. See J. Stratton Shartel, *Securities Arbitration Attorneys Describe Diverse Strategies*, 8 SEC. ARB. 14, 14 (1994), available in LEXIS, News Library, CURNWS File.

69. Shartel, *supra* note 68, at 14.

70. Seamons, *supra* note 45, at 387.

71. Former Vice-President Dan Quayle has spoken repeatedly on this topic. The Supreme Court has frequently accepted punitive damages cases. See *infra* Part III. See generally Margaret A. Jacobs & Michael Siconolfi, *Losing Battles, Investors Fare Poorly Fighting Wall Street - And May Do Worse*, WALL ST. J., Feb. 8, 1995, at A1; Richard Pérez-Peña, *U.S. Juries Grow Tougher on Those Seeking Damages*, N.Y. TIMES, June 17, 1994, at A1 & B18; 5 SEC. ARB. COMMENTATOR (No. 7) May 1993, *Chart G*, at 10; Franklin D. Ormsten,

II. THE LAW OF PUNITIVE DAMAGES⁷²

Punitive, or exemplary, damage awards represent an amount in excess of damages needed to compensate victims. Such awards are predicated on findings that defendants' actions were malicious, willful, reckless, or outrageous.⁷³ Such damages are assessed as civil fines for flagrant or egregious misconduct and are usually awarded directly to the plaintiffs. The ostensible goals of these awards are punishment and deterrence. The same justifications underlie criminal prosecutions, and thus the perception exists that punitive damages are quasi-criminal in nature, and therefore merit a greater degree of scrutiny than general civil damage awards.⁷⁴

A. Principles Governing the Award of Punitive Damages

The Supreme Court has taken an abiding interest in punitive damages and has considered numerous challenges to these awards based on Eighth Amendment, and most recently, Fourteenth Amendment theories. The result has been a series of decisions which agree that punitive damages are a matter of great concern and merit review to ensure that substantive and procedural due process is met. Nonetheless these decisions lack harmony as to what level of review is required. Under the common law, punitive damages were determined "by a jury instructed to consider the gravity of the wrong and the need to deter similar wrongful conduct. The jury's determination is then reviewed by trial and appellate courts to ensure that it is reasonable."⁷⁵

In *Pacific Mutual Life Insurance Co. v. Haslip*, the Court considered, *inter alia*, whether a punitive damages award violated the Due Process Clause.⁷⁶ Rejecting the challenge to an award over four times greater than the amount of compensatory damages (and 200 times greater than out-of-pocket expenses), the Court concluded that the state standard of review "imposes a sufficiently definite and meaningful constraint on the discretion" of the jury so as not to offend the Due Process Clause.⁷⁷ Even while refusing to "draw a mathematical bright line," the Court developed a general "reasonableness" test and found the review procedure acceptable where the jury was instructed as to the nature and purpose of punitive damages, identified the damages as punishment for civil

Punitive Damages in Securities Arbitration, N.Y.L.J., Jan. 21, 1993, at 1; George H. Friedman, *Punitive Damages in Securities Cases*, N.Y.L.J., May 2, 1991, at 3.

72. Subpart A of this section discusses principles that the Supreme Court has enunciated with respect to punitive damages awards. Subpart B discusses the availability of punitive damages as a remedy in arbitration.

73. See generally Katsoris, *supra* note 30, at 574-76 (citing existence of punitive damages for thousands of years); Stephen Daniels & Joanne Martin, *Myth and Reality in Punitive Damages*, 75 MINN. L. REV. 1, 6 (1990); David G. Owen, *The Moral Foundations of Punitive Damages*, 40 ALA. L. REV. 705, 705 (1989).

74. See generally Margo E. K. Reder, *Punitive Damages Awards: The Courts' Role, and Limitations of Review*, 27 BUS. L. REV. 59, 59-60 (1994).

75. *Pacific Mut. Life Ins., Co. v. Haslip*, 499 U.S. 1, 15 (1991); *cf.* *Browning-Ferris Indus., Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257 (1989).

76. *Haslip*, 499 U.S. at 15.

77. *Id.* at 22-23. The Court also reviewed on substantive due process grounds, but mainly focused on the procedural aspect of the due process mandate. *Id.*

wrongdoing, and explained that their imposition was not compulsory.⁷⁸

In *TXO Production Corp. v. Alliance Resources Corp.*, the Court heard a challenge to a \$10 million punitive damages award—526 times greater than the actual damages of \$19,000.⁷⁹ The Court again rejected the challenge, concluding that the award was not so excessive as to be an arbitrary deprivation of property without due process of law.⁸⁰ The Court echoed its ruling in *Haslip*, which relied on a “reasonableness” test, and found that the trial judge’s review of the award, while somewhat lacking, was sufficient.⁸¹

Most recently, in *Honda Motor Co. v. Oberg*, the Court heard a challenge to a \$5 million punitive damages award where the compensatory damages were just under \$1 million.⁸² In Oregon, where the case arose, an amendment to the state constitution prohibited judicial review of the amount of a punitive damages award unless there was no evidence to support it.⁸³ Finding that Oregon’s procedures failed to sufficiently limit juries’ discretion in their award of punitive damages, the Court concluded that Oregon’s low level of review violated the Fourteenth Amendment’s Due Process Clause.⁸⁴ The Court dismissed the procedures that the Oregon courts followed, criticizing them as inadequate to assure that there are no arbitrary deprivations of property.⁸⁵

From these three recent cases, two principles become clear. First, the Supreme Court has decided that the Constitution, through the Fourteenth Amendment’s Due Process Clause, imposes a substantive limit on the size of punitive damages awards.⁸⁶ And second, the Due Process Clause has a procedural component mandating a level of judicial review over a jury’s decision in order to avoid the danger of an arbitrary deprivation of property.⁸⁷ There is, however, a significant difference of opinion among the Justices as to what standard of review is necessary. Most recently, in *Oberg*, Justice Ginsburg, joined by Chief Justice Rehnquist in the dissent, asserted that even though Oregon’s procedures were lacking in appellate review, safeguards existed and were adequate to ensure due

78. *Id.* at 18-24.

79. 113 S. Ct. 2711, 2717-18 (1993).

80. *Id.* The Court apparently agreed with the lower court that the *potential* for harm from such behavior as the defendants engaged in merited such an award in order to discourage similar practices. *See TXO Prod. Corp. v. Alliance Resources Corp.*, 419 S.E.2d 870, 889 (W.Va. 1992).

81. *See TXO*, 113 S. Ct. at 2723-24.

82. 114 S. Ct. 2331, 2334 (1994).

83. *Id.* at 2338, 2338 n.5. *But see id.* at 2344-46 (Ginsburg, J., dissenting) (Oregon’s procedures, requiring clear and convincing evidence of entitlement to punitive damages, “pass the Constitution’s due process threshold.”)

84. *Id.* at 2340-42.

85. *Id.* *But see id.* at 2349-50 (Ginsburg, J., dissenting). *See also* Paul M. Barrett, *Supreme Court Rules Punitive Award in Oregon Case Was Unconstitutional*, WALL ST. J., June 27, 1994, at B4; Linda Greenhouse, *Punitive Damage Awards by Juries Must Be Subject to Judicial Review, Justices Rule*, N.Y. TIMES, June 25, 1994, at 11; *cf.* Pérez-Peña, *supra* note 71, at B18.

86. *Pacific Mut. Life Ins., Co v. Haslip*, 499 U.S. 1, 1 (1991). *See TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711, 2720-21 (1993). *See generally* Reder, *supra* note 74.

87. *Haslip*, 499 U.S. at 18-23. *Cf. TXO*, 113 S. Ct. at 2718-20 (Court rejected parties’ arguments to adopt either a “heightened scrutiny” test or a “rational basis” test for analyzing constitutionality of judicial review procedures).

process.⁸⁸ The dissent's approach would radically limit Supreme Court review of punitive damages and leave it to the states as a matter of their discretion.⁸⁹ While Justice Scalia concurred in the *TXO* judgment, he also criticized the present procedural due process approach, characterizing it as a "clumsy" way to impose a standard of "reasonable punitive damages."⁹⁰

However it evolves, this reasonableness test is most relevant to the constitutionality of punitive damages awards in arbitration cases. In fact, it should be anticipated, subsequent to *Mastrobuono*, that the next question will be whether the arbitrator's procedure is flawed or whether the punitive damages award is so excessive as to violate the Due Process Clause.

B. Punitive Damages Awards and Arbitration

Under the FAA, courts are required to enforce arbitrators' awards "unless the award is vacated under the rules set forth in section 10."⁹¹ Awards may be vacated only upon evidence of fraud, corruption, bias, material misconduct, abuse of power or other similar findings.⁹² In other words, there must have been some manifest disregard of the law. Awards may be modified upon such grounds as clear evidence of a "material mistake," or where "the award is imperfect in matter of form not affecting the merits of the controversy."⁹³ Clearly, there is presently no evidence of an abiding interest in reviewing arbitrators' decisions.

The award of punitive damages, however, is peculiarly susceptible to review because of the nature of the damages. Further, the availability of such damages has historically been a matter of state law and in general the measure of such damages is controlled by state law. Therefore, in a diversity action where state law provides the basis for the decision, the propriety of an award of punitive damages typically becomes a question of state law.⁹⁴ Arbitration agreements today are typically based on commercial transactions governed by contracts. State courts have been less willing to grant punitive damages awards in this context than, for example, suits involving claims for tortious damages.

The most notable case opposing punitive damages in arbitration is *Garrity v. Lyle Stuart, Inc.*⁹⁵ The New York State court in *Garrity* considered whether the arbitrator had power to award punitive damages in a contract dispute upon finding that the defendant publisher wrongfully withheld royalties from the plaintiff author.⁹⁶ In a 4-3 decision, the court ruled that arbitrators have "no power to award punitive damages, even if agreed

88. *Oberg*, 114 S.Ct. at 2348-50. (Ginsburg, J., dissenting).

89. *Id.* at 2343-50; cf. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477-79 (1989).

90. *TXO*, 113 S.Ct. at 2728 (Scalia, J., concurring); see Kenneth R. Davis, *Due Process Right to Judicial Review of Arbitral Punitive Damages Awards*, 32 AM. BUS. L.J. 583 (1995).

91. 9 U.S.C. §§ 9, 10 (1994). See generally Marta B. Varela, *Arbitration and the Doctrine of Manifest Disregard*, DIS. RES. J., June 1994, at 64.

92. 9 U.S.C. § 10 (1994).

93. *Id.* § 11.

94. See *Browning-Ferris Indus. v. Kelco Disposal, Inc.*, 492 U.S. 257, 278 (1989).

95. 353 N.E.2d 793 (N.Y. 1976).

96. *Id.* at 794.

upon by the parties.”⁹⁷ Basing its decision on “strong public policy indeed,” the court concluded that punitive damages are not available for “mere breach of contract, for in such a case only a private wrong, and not a public right is involved”⁹⁸ The court reasoned that the imposition of punitive sanctions is a social remedy requiring judicial oversight that is beyond the province of private tribunals. Issued in 1976, this opinion at its worst, parallels the history of “judicial hostility to arbitration agreements” that has existed over the centuries.⁹⁹

The *Garrity* rule has been adopted by many courts and jurisdictions.¹⁰⁰ However, the rationale and soundness of the decision is questionable due to the extent that the law of arbitration has matured and the fact that the use of such agreements is so broad and so common at this time. In fact, the *Garrity* dissent pointed out that refusing to allow arbitrators the power to award punitive damages for a contract arbitration on public policy grounds has the effect of favoring “a guileful defendant and voids a just and rational award . . . to a wholly innocent . . . plaintiff. Arbitrators are entitled to ‘do justice . . . [and] short of complete irrationality, they may fashion the law to fit the facts before them.’”¹⁰¹ In short, the *Garrity* jurisdictions greatly undermine the powers the FAA grants to arbitrators. This has a pernicious effect of unduly and needlessly complicating the arbitration process by injecting into it arcane state choice of law issues, which were to be avoided by virtue of signing an agreement to arbitrate, rather than litigate disputes that arise.¹⁰²

The availability of punitive damages in arbitration proceedings has been, and to some extent, will continue to be controversial. This is true where agreements are silent on the availability of such damages and state law is either silent on the subject or expressly disallows them. Federal courts in a diversity proceeding must attempt to reconcile the FAA, which grants arbitrators full power to fashion appropriate remedies, and state laws (due to a choice of law clause in the PDAA) that disallow punitive damages awards in arbitration. Attempting to determine whether punitive damages awards are a matter of substantive or procedural law (whereby punitive damages would be available under the former but not the latter) is a flawed analytical framework. This side-steps the real issue of how much power arbitrators should have to fashion remedies for disputes that would previously have been decided in court. Arbitrators must have powers that are comparable

97. *Id.*

98. *Id.* at 795.

99. *Scherk v. Alberto-Culver, Co.*, 417 U.S. 506, 510 (1974).

100. See *Fahnestock & Co. v. Waltman*, 953 F.2d 512 (2d Cir. 1991), *cert. denied*, 502 U.S. 1120 (1992); *Independent Employees' Union v. Hillshire Farm Co.*, 826 F.2d 530 (7th Cir. 1987); *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984); *Shahmirzadi v. Smith Barney, Harris Upham & Co.*, 636 F. Supp. 49 (D.D.C. 1985); *McLeroy v. Waller*, 731 S.W.2d 789 (Ark. Ct. App. 1987); *United States Fidelity & Guar. v. DeFluiter*, 456 N.E.2d 429 (Ind. Ct. App. 1983); *Shaw v. Kuhnel & Assoc., Inc.*, 698 P.2d 880 (N.M. 1985). See generally *Miller Brewing Co. v. Brewery Workers Local Union*, 739 F.2d 1159, 1164 (7th Cir. 1984), *cert. denied*, 469 U.S. 1160 (1985) (asserting that “arbitrators are rarely thought authorized to award punitive damages”).

101. *Garrity*, 353 N.E.2d at 797, 800.

102. See generally *Sarnoff v. American Home Prods. Corp.*, 798 F.2d 1075 (7th Cir. 1986); *Potomac Leasing Co. v. Chuck's Pub, Inc.*, 509 N.E.2d 751 (Ill. App. 1987); *McAllister v. Smith*, 17 Ill. 328 (1856).

to those of a court if arbitration is to be recognized as a legitimate system of dispute resolution.

III. PUNITIVE DAMAGES IN SECURITIES ARBITRATION¹⁰³

Punitive damages awards are not available for claims under the federal securities acts.¹⁰⁴ However, such awards are permissible *in courts* when plaintiffs join pendant state claims with the federal claims where the underlying state law so provides. Of course, the issue here revolves around the power to award punitive damages *in arbitration*.¹⁰⁵ Securities arbitration clauses are required of investors by broker-dealer firms as a condition of doing business. In some cases investors have a choice of arbitration forum in that they may elect arbitration by the independent American Arbitration Association (AAA).¹⁰⁶ More often than not though, investors must elect between different industry sponsored arbitration forums that are ultimately regulated by the Securities and Exchange Commission.¹⁰⁷

Under AAA rules, arbitrators are empowered to "grant any remedy or relief which is just and equitable and within the terms of the agreement of the parties."¹⁰⁸ Although the AAA rules do not explicitly mention punitive damages, the AAA language is quite broad and has been construed to support an award of punitive damages, providing that it is within the scope of the parties' agreement. Industry sponsored forums differ to an extent. New York Stock Exchange (NYSE) rules, and the Code of Arbitration Procedures of the National Association of Securities Dealers (NASD) are silent on the issue of punitive damages.¹⁰⁹ Notwithstanding the NASD's Code, its Arbitrator's Manual states that arbitrators can consider punitive damages as a remedy.¹¹⁰

Therefore, when investors sign a PDAA they may elect an arbitration forum that may or may not specifically allow arbitrators to award punitive damages, but might

103. Subpart A of this section discusses the lower courts' decisions. Subpart B addresses the Supreme Court's decision in *Mastrobuono*.

104. Section 28(a) of the Securities Exchange Act of 1934 limits recovery to actual damages. See 15 U.S.C. § 78bb (1994). Section 17a of the Securities Act of 1933 does not sustain an award of punitive damages. See 15 U.S.C. § 77q(a) (1994). See generally *Carras v. Burns*, 516 F.2d 251, 259-60 (4th Cir. 1975); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

105. Compare Brief for Petitioners at 25, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (pursuant to federal law parties may agree to arbitrate punitive claims) with Brief for Respondents at 43-44, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (Congress never deemed it necessary to confer "right" to seek punitive damages and they may not seek them under federal securities laws).

106. U.S. GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE: REPORT TO CONGRESSIONAL REQUESTERS 31-33 (May 1992) [hereinafter GAO REP'T] (noting large firms seldom include AAA as an alternative forum despite SECs encouragement to do so).

107. *Id.* at 5.

108. *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6, 9-10 (1st Cir. 1989).

109. See *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 831 (1993), *cert. denied*, 114 S. Ct. 2182 (1994); Respondent's Brief, *supra* note 105.

110. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 717 (7th Cir. 1994).

nevertheless be broad enough in language to empower them to make such awards. Second, investors historically have signed PDAA's containing a New York choice of law clause even when they have no connection there and the transactions occur elsewhere. Recall that under New York law, punitive damages may never be awarded in a contract dispute *even if the parties agreed to them*. It is notable that none of the standard form agreements explains the significance and effect of the New York choice of law clause, which dramatically favors brokers, and not surprisingly, negatively impacts investors.

At this time it is helpful to recap the issues involving challenges to punitive damages in securities arbitrations. There are substantive and procedural aspects to punitive damages, and a patchwork of federal and state rules in this area. Securities disputes, likewise, are governed by state and federal laws. Arbitration is primarily regulated by federal law, yet the agreements often simultaneously contain disparate clauses. They offer punitive damages with one hand through an arbitration forum selection clause, yet take away the awards with the other hand through devices such as a New York choice of law clause.

Do investors waive the right to recover punitive damages by signing a PDAA when it is governed by a *Garrity* type clause? This is among the issues considered by the *Mastrobuono* Court. Prior to this decision a number of courts considered this issue, and reached conflicting results. The Court of Appeals for the Second Circuit¹¹¹ as well as the Seventh Circuit Court of Appeals¹¹² and the District Court for the District of Columbia¹¹³ disallowed awards of punitive damages, reasoning that *Garrity* was controlling despite federal arbitration law. The Courts of Appeals for the First,¹¹⁴ Fifth,¹¹⁵ Eighth,¹¹⁶ Ninth,¹¹⁷ and Eleventh¹¹⁸ Circuit Courts (along with district courts in North Carolina¹¹⁹ and South Dakota¹²⁰ and a California state court¹²¹) upheld awards of punitive damages, reasoning that strong federal policy favoring arbitration took precedence over state laws.

111. *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2d Cir. 1991); *Fahnestock & Co. v. Waltman*, 953 F.2d 512 (2d Cir. 1991); *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976).

112. *Mastrobuono*, 20 F.3d at 713; *accord* *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984); *cf.* *Baselski v. Paine, Webber, Jackson & Curtis, Inc.*, 514 F. Supp. 535 (N.D. Ill. 1981). *But cf.* *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir., 1994) (upholding punitive damages award of \$120,000 based upon compensatory damages of \$60,000 for tortious conduct arising under the contract to be arbitrated).

113. *Shamirzadi v. Smith Barney, Harris Upham & Co.*, 636 F. Supp. 49 (D.D.C. 1985).

114. *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *cf.* *Escobar v. Shearson Lehman Hutton, Inc.*, 762 F. Supp. 461 (D. P.R. 1991).

115. *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981).

116. *Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993).

117. *Todd Shipyards Corp. v. Cunard Line, LTD.*, 943 F.2d 1056 (9th Cir. 1991).

118. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); *Singer v. E.F. Hutton & Co.*, 699 F. Supp. 276 (S.D. Fla. 1988). *See generally* *Willoughby Roofing and Supply Co. v. Kajima Int'l, Inc.*, 776 F.2d 269 (11th Cir. 1985), *aff'g* 598 F. Supp. 353 (N.D. Ala. 1984).

119. *Willis v. Shearson/American Express, Inc.*, 569 F. Supp. 821 (M.D.N.C. 1983).

120. *Ehrich v. A.G. Edwards & Sons, Inc.*, 675 F. Supp. 559 (D.S.D. 1987).

121. *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826 (1993).

A. *The Split Among the Circuit Courts Regarding the Power of Arbitrators to Award Punitive Damages in Securities Arbitrations*

1. *Decisions Upholding Punitive Damages Awards.*—

a. *First Circuit: Raytheon Co. v. Automated Business Systems, Inc.*¹²²—The court in *Raytheon* considered whether commercial arbitrators have the power to award punitive damages pursuant to a general arbitration clause not specifically addressing such damages.¹²³ The parties' agreement incorporated AAA rules. California was selected under a choice of law clause, but the court disregarded this choice and instead looked to federal common law for guidance.¹²⁴ Noting that arbitration was required for *all* disputes arising from the contract, and that AAA Rule 42 (now Rule 43) empowers arbitrators to grant any remedy which is (1) equitable, and (2) within the terms of the parties' agreement, the First Circuit questioned whether a punitive damages award was a remedy the parties agreed to include.¹²⁵ The court concluded that arbitrators were authorized to award punitive damages, finding that the contract language, as well as case law, supported a broad interpretation of arbitrators' powers.¹²⁶ The court specifically observed that where punitive damages could be awarded in court, the change in forum to an arbitration setting should not result in a change of law and prohibit a party from recovering the same damages.¹²⁷

b. *Fifth Circuit: Miley v. Oppenheimer & Co.*¹²⁸—This case pre-dates *McMahon* and is included even though its *dicta* is the only support for securities arbitration.¹²⁹ In *Miley*, the investor prevailed in her securities fraud suit, and the broker challenged the trial court's refusal to order arbitration of pendant state law securities claims.¹³⁰ At the time of the holding, federal securities law claims could not be subjected to arbitration.¹³¹ The Fifth Circuit followed this precedent but noted that "the parties have a right, if they so desire, to have an arbitrator decide whether there was sufficient misconduct . . ." ¹³²

122. 882 F.2d 6 (1st Cir. 1989).

123. *Id.* Damages were awarded in arbitration as follows: Compensatory \$408,000; Attorney's Fees \$121,000; Expenses \$47,000; Punitive \$250,000. *Id.* at 7.

124. *Id.* at 7, 11 n.5. See John F. X. Peloso & Stuart M. Sarnoff, *Punitive Damages in Arbitration*, N.Y.L.J., Aug. 18, 1994, at 3, 27; Ormsten, *supra* note 71, at 1, 31 (*Raytheon* rejected *Garrity* and narrowly construed *Volt*).

125. *Raytheon*, 882 F.2d at 9-10. See also Sabino, *supra* note 3, at 54-57 (questions on scope of power resolved by *Raytheon* court in favor of arbitration).

126. *Raytheon*, 882 F.2d at 10-12 (court reached this result after considering language of agreement including AAA clause as well as intent of parties, and explicitly rejected thesis that arbitrators must have explicit contractual authority to award punitive damages).

127. *Id.* at 10, 12. Justice Breyer was previously a member of the *Raytheon* panel of judges. Cf. Escobar v. Shearson Lehman Hutton, Inc., 762 F. Supp. 461 (D. P.R. 1991).

128. 637 F.2d 318 (5th Cir. 1981).

129. *Id.* at 336 n.15. Damages were awarded as follows: Compensatory \$54,000; Punitive \$100,000. *Id.* at 326, 331.

130. *Id.* at 334-37.

131. See *Wilko v. Swan*, 346 U.S. 427 (1953).

132. *Miley*, 637 F.2d at 336.

c. *Eighth Circuit: Lee v. Chica*.¹³³—Judy Lee, an investor, signed a securities account agreement stating that arbitration would be governed by Minnesota law, which had been construed to prohibit punitive damages, yet “AAA Rule 43 specifically allow[ed for] . . . punitive damages.”¹³⁴ The court was asked to consider which law to apply.¹³⁵ Without formally adopting a preemption approach to the issue, the court declared that, “[a]rbitrability of contracts evidencing interstate commerce is governed by federal substantive law rather than state law.”¹³⁶ The court cited with approval the decisions of the First, Ninth and Eleventh Circuits, and held that pursuant to AAA rules, “arbitrators may grant any remedy or relief including punitive damages.”¹³⁷ It specifically distinguished its decision from those following Second Circuit precedent, stating that in *Lee* the state law was unclear and that AAA rules were very broad, whereas in *Garrity* type cases, the state law was clear and broad AAA rules were not incorporated.¹³⁸

Judge Beam dissented in *Lee*, and articulated many concerns that may prove to be a harbinger for future cases. He recognized that AAA rules speak in terms of “remedy or relief” and “compensation,” and are silent about punishing the defendant.¹³⁹ He advised against expanding the scope of the proceedings beyond the terms *actually* agreed upon and cautioned that punitive damages awards are subject to constitutional constraints such as those enunciated in *Haslip* and its progeny.¹⁴⁰ To comport with such requirements, Judge Beam asserted that it would necessitate a total change in arbitration rules for consideration of punitive damages awards.

d. *Ninth Circuit: Todd Shipyards Corp. v. Cunard Line, LTD*.¹⁴¹—Todd filed a demand for arbitration alleging, *inter alia*, breach of contract.¹⁴² The parties’ commercial arbitration agreement specified that New York law governed and that AAA rules applied.¹⁴³ Rejecting Cunard’s contention that *Volt* and New York law governed, the *Todd* court expressed that the “Supreme Court has said time and again that issues of arbitrability in cases subject to the Act [FAA] are governed by federal law.”¹⁴⁴ The court agreed with “the expansive view that . . . the power of arbitrators to decide disputes, coupled with the incorporation of AAA . . . Rule 43 . . . provided the arbitration panel here with authority to make the punitive damage award.”¹⁴⁵ Like *Lee*, the *Todd* court found it significant,

133. 983 F.2d 883 (8th Cir. 1993), *cert. denied*, 114 S. Ct. 287 (1993).

134. *Id.* at 885, 887 n.6. Damages were awarded as follows: Compensatory \$10,000; Attorney’s Fees \$5,000; Punitive \$31,800. *Id.* at 885.

135. *Id.* at 887.

136. *Id.* at 886.

137. *Id.* at 887.

138. *Id.* at 888 n.7.

139. *Id.* at 889 (Beam, J., dissenting).

140. *Id.*

141. 943 F.2d 1056 (9th Cir. 1991).

142. *Id.* at 1059. Damages were awarded as follows: Compensatory \$6 million; Punitive \$1 million. *Id.* at 1060-61.

143. *Id.* at 1059 n.1, 1061 n.2.

144. *Id.* at 1062.

145. *Id.* at 1063.

even dispositive, that AAA rules were part of the contract.¹⁴⁶ Such rules are then construed to override contrary choice of law clauses.

*e. Eleventh Circuit: Bonar v. Dean Witter Reynolds, Inc.*¹⁴⁷—The Bonars filed a demand for arbitration with the AAA, seeking compensatory and punitive damages against the brokerage firm.¹⁴⁸ Even though Dean Witter successfully challenged the investor's expert witness on grounds of perjury, the court upheld the power of arbitrators to award punitive damages.¹⁴⁹ The court first considered the interplay between AAA rules and the agreement's New York choice of law clause. Under the rule of construction established in *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*,¹⁵⁰ the *Bonar* court found that the FAA and the customer agreement authorized punitive damages. Therefore, the additional choice of law clause did not deprive arbitrators of this power.¹⁵¹ Second, and more interesting for future litigation, the court considered whether the customers waived their right to punitive damages by signing the customer agreement. Since the agreement never mentioned punitive damages, the court found there could be no waiver because the agreement is thereby ambiguous and not a "voluntary and intentional relinquishment of a known right."¹⁵²

The concurring opinion in *Bonar* also raises a provocative question for future litigation by focusing on the actual intent of the parties. The *Bonar* majority and other courts upholding punitive damages awards have presumed, as the AAA requires, that such relief is contemplated by the parties. Yet Judge Tjoflat pointed out that all the parties really did was agree to submit *contract disputes* to arbitration, and that punitive damages should be available only if there is an express provision in the agreement authorizing them.¹⁵³

f. Lower courts.—

*(i) Ehrich v. A.G. Edwards & Sons, Inc.*¹⁵⁴—Lorraine Ehrich petitioned the court for confirmation of an arbitration award including punitive damages. Under state law, punitive damages were available, and AAA rules governed.¹⁵⁵ The court rejected the *Garrity* rule, reasoning that federal law applied pursuant to the FAA. It upheld the arbitrator's ability to "fashion appropriate remedies" and found that punitive damages

146. *Id.* at 1063 n.6. See also Peloso & Sarnoff, *supra* note 124, at 27; Edward Brodsky, *Punitive Damages in Arbitration*, N.Y.L.J., April 13, 1994, at 3, 11 (federal law applied to issue of arbitrators' power and New York law applied to setting amount of damages); Carolyn M. Penna, *Enforceability of Punitive Damages Awards*, N.Y.L.J., Dec. 5, 1991, at 3, 7.

147. 835 F.2d 1378 (11th Cir. 1988).

148. *Id.* at 1380. Damages were assessed as follows: Compensatory \$9,007.32; Punitive \$150,000. *Id.* at 1380 n.3, 1381.

149. *Id.* at 1380-81, 1387.

150. 598 F. Supp. 353 (N.D. Ala. 1984).

151. *Bonar*, 835 F.2d at 1387. See *Willoughby*, 598 F. Supp. at 353; Ormsten, *supra* note 71, at 31. *Accord* Singer v. E.F. Hutton & Co., 699 F. Supp. 276 (S.D. Fla. 1988).

152. *Bonar*, 835 F.2d at 1387.

153. *Id.* at 1388-89 (Tjoflat, J., concurring).

154. 675 F. Supp. 559 (D.S.D. 1987).

155. *Id.* at 563 n.7, 564 & n.8. Damages were awarded as follows: Compensatory \$193,444; Punitive \$97,341. *Id.* at 560-61.

were within the scope of the parties' agreement to arbitrate.¹⁵⁶

(ii) *Willis v. Shearson/American Express, Inc.*¹⁵⁷—In *Willis*, the customer filed suit in court for securities fraud and the brokerage firm motioned to stay proceedings pending an arbitration of the claims pursuant to the parties' agreement. The *Willis* court distanced itself from *Garrity* pointing out that the latter dealt only with the powers of arbitrators under state law and that since the FAA is applicable here, federal law controls.¹⁵⁸ Accordingly the court ordered arbitration, warning that if "an issue is arbitrable under federal law, it remains so despite contrary state law."¹⁵⁹

(iii) *J. Alexander Securities, Inc. v. Mendez*.¹⁶⁰—In *Mendez*, the securities firm appealed from the judgment against it which included punitive damages. The agreement incorporated NASD rules and a New York choice of law clause.¹⁶¹ Like *Bonar*, the court reconciled federal and state law, whereby federal law vested arbitrators with the power to award punitive damages, and the choice of law provision was used only to determine whether the facts of the case were sufficiently egregious so that such damages were warranted.¹⁶²

As to the issue of the parties' intent and whether they contemplated an award of punitive damages when they entered into their agreement, the court concurred with the other courts that have upheld awards of punitive damages. It reasoned that since the language was unclear, neither including nor excluding the award of punitive damages, it would look to other contract clauses. The court found the other clauses "sufficiently broad to encompass the award[] of punitive damages,"¹⁶³ and it reached this conclusion despite the fact that AAA rules did not govern the arbitration. This is the broadest interpretation yet of NASD rules and is based on "prevailing policy in California."¹⁶⁴

2. Decisions Invalidating Punitive Damages Awards.—

a. *Second Circuit: Barbier v. Shearson Lehman Hutton, Inc.*¹⁶⁵—The Barbiers filed a claim of arbitration upon learning that their investment account had been nearly depleted. The parties' agreement was governed by a New York choice of law clause and they chose to arbitrate under NYSE rules.¹⁶⁶ The broker and firm filed a motion to vacate the entire award to the Barbiers, a portion of which included punitive damages. The court made quick work of resolving the issue because it found the choice of law clause, which adopted the New York rule prohibiting punitive damages, to be dispositive. In form, the

156. *Id.* at 565.

157. 569 F. Supp. 821 (M.D.N.C. 1983).

158. *Id.* at 823.

159. *Id.* at 824-25. The arbitration provision was identical to that in *Barbier* and *Mastrobuono*. See *infra* notes 165-172.

160. 21 Cal. Rptr. 2d 826 (Cal. Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994).

161. *Id.* at 827-28. In the Supreme Court's denial of *certiorari*, a dissent urged the majority to reconsider, noting that this decision in *Mendez* irreconcilably conflicts with the Seventh Circuit's *Mastrobuono* decision. Damages in *Mendez* were awarded as follows: Compensatory \$27,000; Punitive \$27,000.

162. *Id.* at 830. See *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988).

163. *Mendez*, 21 Cal. Rptr. 2d at 830-31.

164. *Id.* at 831. The court expressly distinguished itself from *Fahnestock* and *Barbier*.

165. 948 F.2d 117 (2d Cir. 1991).

166. *Id.* at 119. Damages were awarded as follows: Compensatory \$130,645; Punitive \$ 25,000. *Id.*

facts are most closely aligned with those of the *Mendez* case, yet the results irreconcilably conflict. The *Barbier* court relied heavily on *Volt*, which observed that the FAA mandates enforcement of private agreements according to their terms. The court reasoned that since the parties "elected to abide" by New York law, they would be held to their bargain.¹⁶⁷ Although there was room in such a response to question the parties' intent, the court refused to consider it. This case must certainly rank among the least distinguished of Second Circuit opinions, as it is devoid of depth of analysis and consideration of the equities of the parties.

b. *Seventh Circuit: Mastrobuono v. Shearson Lehman Hutton, Inc.*¹⁶⁸—As in *Mendez* and *Barbier*, the parties in *Mastrobuono* signed a PDAA that was governed by a New York choice of law clause, and submitted their dispute to arbitration under NASD rules. The NASD Code of Arbitration Procedures made no mention of punitive damages, but its Arbitrator's Manual specifically allowed for punitive damages as a remedy.¹⁶⁹ Recognizing the conflict between the courts considering such issues, the *Mastrobuono* court opted to follow the implications of its previous decisions,¹⁷⁰ and favored the choice of law clause over the choice of arbitration rules clause.¹⁷¹ Thus, in its words, "the *Garrity* rule always controls," regardless of the arbitration rules agreed upon.¹⁷² Because the Seventh Circuit concluded that all disputes were subject to *Garrity*, it reasoned that there was no need to consider preemption issues in reliance on *Volt*, which acknowledged that state laws may co-exist with federal laws under certain conditions.

c. *Lower courts.*—

(i) *Shahmirzadi v. Smith Barney, Harris Upham & Co.*¹⁷³—In this early case, when federal securities claims were not yet considered arbitrable, it was typical that the plaintiff customers filed suit in court and the brokerage firm sought arbitration. The PDAA was governed by New York law and arbitration rules were to be chosen among those of the NYSE, NASD or AMEX.¹⁷⁴ The court rejected the Shahmirzadis' attempt to invalidate

167. *Id.* at 122. See *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2d Cir. 1991) (involving an employer-employee arbitration in which a punitive damages award of \$100,000 based on damages of \$156,000 was vacated pursuant to *Garrity*). See generally *Smith Barney, Harris Upham & Co. v. Luckie*, Nos. 11 & 13, 1995 N.Y. LEXIS 233 (Feb. 21, 1995) (statute of limitations issue to be resolved by court rather than arbitrator since parties chose New York law).

168. 20 F.3d 713 (7th Cir. 1994), *rev'd*, 115 S. Ct. 1212 (1995).

169. *Id.* at 717. See also *Mastrobuono*, 812 F. Supp. 845 (N.D. Ill. 1993); *Mastrobuono*, 128 F.R.D. 243 (N.D. Ill. 1989). Damages were awarded as follows: Compensatory \$159,327; Punitive \$400,000. *Mastrobuono*, 20 F.3d at 715. Cf. *Baselski v. Paine, Webber, Jackson & Curtis, Inc.*, 514 F. Supp. 535 (N.D. Ill. 1981).

170. See *Independent Employees' Union v. Hillshire Farm Co.*, 826 F.2d 530 (7th Cir. 1987) (noting arbitral remedies rarely include punitives); *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984) (finding that plaintiffs' failure to inquire about arbitration clause language is not a sufficient reason to avoid its consequences).

171. *Mastrobuono*, 20 F.3d at 717-18. The court characterized this as the "more sensible" approach. *Id.* at 717. But cf. *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994) (upholding award of punitive damages in arbitration involving tort, rather than contract issues).

172. *Mastrobuono*, 20 F.3d at 718.

173. 636 F. Supp. 49 (D.D.C. 1985).

174. *Id.* at 55-56.

the PDAA and found that “the signing . . . of the . . . agreement, which was governed by New York law and included an arbitration clause, was a contractual waiver of the right to punitive damages.”¹⁷⁵ Like other courts relying on *Garrity*, the court refused to consider the parties’ intent as to whether signing the PDAA containing a New York choice of law clause amounted to a knowing and voluntary waiver. The effect, of course, rewards brokers for drafting clauses without explaining their significance to customers; it penalizes customers for not asking about each word in agreements that are not truly bargained for exchanges between parties of equal negotiating power, but were instead issued to them on a take-it-or-leave-it basis.

B. *The United States Supreme Court’s Decision*

1. *Mastrobuono v. Shearson Lehman Hutton, Inc.*¹⁷⁶—Shortly after *Mendez* and faced with a mounting body of conflicting opinions, the Supreme Court granted *certiorari* in *Mastrobuono*. It considered whether the Seventh Circuit erred in holding that state rather than federal law governs the arbitrability of claims for punitive damages, and whether a party waives the right to such awards when signing a PDAA with a New York-style choice of law clause.¹⁷⁷ The investors asked the Court “to hold that the FAA preempts New York’s prohibition against arbitral awards of punitive damages because this state law is a vestige of the ‘ “ ‘ancient’ ” ’ judicial hostility to arbitration.”¹⁷⁸ The brokerage firm responded by asserting that the choice of law clause “evidences the parties’ express agreement that punitive damages should not be awarded in the arbitration of any dispute arising under their contract.”¹⁷⁹

In determining how best to sort out the two clauses, the Court first considered what effect each would have, had it appeared alone in the PDAA. Viewing the choice of law clause in isolation, the Court declined to read it as broadly as the firm urged, reasoning that as written it still “was not, in itself, an unequivocal exclusion of punitive damages

175. *Id.* at 56.

176. 115 S. Ct. 1212 (1995), *rev’g* 20 F.3d 713 (7th Cir. 1994).

177. *See Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 305 (1994); 63 U.S.L.W. 3281 (U.S. Oct. 11, 1994). *Mendez* recall, was denied review by the Supreme Court, but was accompanied by a dissent, which is unusual for the Court.

178. *Mastrobuono*, 115 S. Ct. at 1215; *see also* Petitioners Brief, *supra* note 105; Brief for the United States and the Securities and Exchange Commission, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (supporting Petitioners assertion that punitive damages are proper remedy); Brief for the Public Investors Arbitration Bar Association, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (asserting that New York law is contrary to the principles that underlie the FAA); Brief for American Association of Limited Partners, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (asserting that the Seventh Circuit’s opinion threatened investors rights by impairing their ability to recover damages). *Cf. Allied - Bruce Terminix Cos. v. Dobson*, 115 S. Ct. 834 (1995) (upholding PDAA in spite of contrary state law).

179. *Mastrobuono*, 115 S. Ct. at 1216; *see also* Respondents Brief, *supra* note 105; Brief for the Securities Industry Association, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713 (7th Cir. 1994) (No. 94-18) (parties chose New York law and must abide by it, and enforcing terms according to the agreement is consistent with *Volt* and the goals of FAA).

claims.”¹⁸⁰ When the Court next considered the arbitration rules clause in isolation, it found that the firm’s argument did not improve.¹⁸¹ When read alone, there is a strong implication that a punitive damages remedy is appropriate since the rules do not purport to limit arbitrators’ discretion in making such awards.¹⁸²

The Court then considered the two clauses together and decided in favor of the investors. It reasoned that, “[a]t most, the choice of law clause introduces an ambiguity into an arbitration agreement that would otherwise allow punitive damages awards.”¹⁸³ The Court relied on two cardinal principles of contract interpretation to reach its conclusion: (1) ambiguities are to be construed against the interests of the drafting party, and (2) documents should be read to give effect to all clauses, reconciling them if at all possible.¹⁸⁴ By calling into question the various interpretations that could be attached to the choice of law clause, and construing this ambiguity against the broker, the Court avoided a *Volt*-type preemption analysis. *Mastrobuono* thus emphasizes that arbitrators have broad powers to resolve disputes, especially where customers have a claim against the brokerage firms that drafted the parties’ agreement.

The eight to one decision was punctuated by a dissent from Justice Thomas, who argued that *Mastrobuono* is virtually indistinguishable from *Volt*, and thus New York law prevails since the FAA simply requires courts to enforce privately negotiated agreements according to their terms.¹⁸⁵ Justice Thomas considered the NASD authorization of punitive damages awards in the Arbitrators’ Manual not even to be part of the NASD rules, and finally, lamented “that the parties made their intent clear, but not in the way divined by the majority.”¹⁸⁶

180. *Mastrobuono*, 115 S. Ct. at 1216-17. The clause stated that the “agreement . . . shall be governed by the laws of the state of New York.” *Id.* at 1216-17 & n.2. Perhaps the firms were reluctant to spell out in such stark terms the meaning and effect of the choice of law clauses.

181. *Id.* at 1218.

182. *Id.* at 1218 n.5. The Court recently heard oral argument on a case concerning the scope of review for arbitrators’ decisions. *See First Options of Chicago, Inc., v. Kaplan*, 115 S. Ct. 634 (1994) (granted *certiorari* to review 19 F.3d 1503 (3d Cir. 1994)).

183. *Mastrobuono*, 115 S. Ct. at 1218. *See also* Karen Donovan, *The Investors Win; Experts Debate Effect*, NAT’L L.J., Mar. 20, 1995, at B1 (citing litigation consultant’s opinion that Court “more or less suggested that clearer drafting could avoid the problem”); *High Court Hears Debate on Award of Punitive Damages in Arbitration*, U.S.L.W., Jan. 11, 1995, available in LEXIS, Genfed Library, USPLUS File. The article summarized comments made at oral argument; Justice O’Connor queried whether parties even contemplated punitive damages; Justice Souter stated that NASD rules were agnostic on such damages; Justice Breyer’s questions were prescient where he asked why there is not at least an ambiguity between the clauses and therefore the parties must abide by the arbitrator’s decision. *Id.*

184. *Mastrobuono*, 115 S. Ct. at 1219; *see also Kelly v. Michaels*, No. 94-5023, 1995 U.S. App. LEXIS 16782 (10th Cir. July 10, 1995) (first appellate decision since *Mastrobuono*, and it upheld a punitive damages award despite a New York choice of law clause).

185. *Mastrobuono*, 115 S. Ct. at 1219-23 (Thomas, J., dissenting).

186. *Id.* at 1223.

IV. SECURITIES ARBITRATION DISPUTES AND PUNITIVE DAMAGES FOLLOWING
MASTROBUONO

What *Mastrobuono* solves and leaves open for further consideration are of course many of the most interesting points. Essentially the Court looked at the PDAA, found ambiguities, and resolved them against the firm which had drafted the document. The case then, is a most helpful warning to firms (and to a lesser extent, customers) that the agreement and exact effect of clauses must be made clearer to average investors. But can't ambiguity be found anywhere if one looks hard enough? It is extremely rare to find the perfect "bulletproof" document, balancing concerns of informed consent with concerns of revealing proprietary information, or other information about the investment process deemed possibly so alarming as to "scare off" investors.

The decision, as sensible as it is, failed to discuss the issue of waiver. Although it would be *dicta* under its holding, waiver issues will arise in future cases, because even when a party signs an agreement, it is unclear when a waiver will effectively relinquish certain rights. Cases following *Garrity* found that parties had waived rights by signing the PDAA even though realistically they did not know the true effect of the New York clause. Can signing this waiver be said to be knowing and voluntary? On the other hand, agreeing with the majority of circuit courts has the effect of rewarding investors who took no steps to inquire about the contents of the PDAA they signed and of the effect of the New York clause. This begs the question of exactly what the parties contemplated. The Supreme Court again did not discuss this in detail because it is impossible to divine the intent of each party. It would suffice to say that the investors probably thought they could pursue all the "usual remedies." The firms probably thought the agreement effectively excluded punitive damages as a remedy.¹⁸⁷ Thus, on this issue there was very likely, no "meeting of the minds" whatsoever. What then can be said for the PDAA as a whole? Does this render the contract null and void, or is the clause severable where intent was lacking and the parties were, most likely, at cross-purposes, at least with respect to remedies?

The better rule is to allow all forms of relief that would have been available had the case been litigated in court. This reinforces the process of arbitration by recognizing its legitimacy as a dispute resolution forum. This is so even if it is somewhat at the expense of the rule of contract construction of precisely determining the parties' intent. It seems that only when PDAAs truly represent the intent of both parties who actively negotiate it and have equal bargaining power, may the parties' intent really be scrutinized by courts to determine whether a party has waived any rights. But because this does not, and will never, realistically occur with standard form agreements, it behooves parties to recall *Mitsubishi's* expansive reading of contract language noting that parties' intentions control, but are generously construed as to issues of arbitrability.

Some judges have expressed a reluctance to infer power to award punitive damages absent express authorization under arbitration rules or state law. To address the related problems of the parties' intent and arbitrators' powers, securities arbitration rules and

187. See *Lee v. Chica*, 983 F.2d 883, 888-89 (8th Cir. 1993) (Beam, J., dissenting); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1388-89 (11th Cir. 1988) (Tjoflat, J., concurring). See generally *Prudential Ins. Co. v. Lai*, 42 F.3d 1299 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 61 (1995) (holding invalid an agreement to arbitrate employment disputes because employees did not knowingly waive their statutory rights).

PDAAs and their relation to state law should be made uniform. To have the process degenerate into a forum-shopping expedition undermines the integrity of the process. There has been a movement to restrict punitive damages awards in securities arbitration, but such plans must be scrutinized closely by the SEC, the main regulatory agency to ensure that all interested parties' positions are considered.¹⁸⁸

Other strategies to unify the rules across all jurisdictions may include a congressional amendment to the FAA that adds a preemption clause reserving plenary power to itself to regulate arbitration, thus precluding any state regulation. This would accomplish what volumes of litigation cannot. It would provide an acceptable level of predictability in the outcome of these cases and would create a rule of law that is recognized and followed. Federalizing punitive damages awards is an object of interest in House Speaker Gingrich's "Contract with America," albeit with the intent of placing caps on such awards.

The *Mastrobuono* Court avoided preemption and Supremacy Clause issues in its discussion—issues surely to arise in future cases unless arbitration is federalized. Because the FAA does not contain a preemption provision, the Court was obliged to read the federal and state laws harmoniously, and to the extent an actual conflict existed, federal law would prevail. The investors in *Mastrobuono* adopted the position that the FAA and the New York choice of law clause actually conflicted, but the Court found that the laws did not, and so construed them to render both valid. This does not, however, totally discourage the practice of quietly inserting clauses favorable to the party who drafted the agreement. Nor does it eradicate the practice of forum-shopping.¹⁸⁹ Furthermore, if as the Court states, interpretation of PDAAs is ultimately a matter of state law, will cases go to those state courts receptive to a certain party's agenda? This scenario further erodes the sound development of law in securities arbitration cases.¹⁹⁰

188. See Michael Siconolfi, *NASD's Bid to Limit Punitive Damages in Arbitration Cases Worries Regulators*, WALL ST. J., Sept. 12, 1994, at A11 (proposal made amid a surge in punitive damages awards); Susan Antilla, *An Arbitration Plan Goes Begging*, N.Y. TIMES, Jan. 9, 1994 § 3, (Business), at 15 (noting unpopularity of NASD's proposal even in securities industry); Barbara Franklin, *Securities Arbitration*, N.Y.L.J., June 3, 1993, at 5 (citing NASD proposals of a cap on damages, minimal standard of egregious behavior to qualify for awards, and allow more review of awards). See generally J. Carter Beese, *Stop Choking Wall Street*, N.Y. TIMES, June 27, 1995, at A17 (supporting changes in securities laws to restrict "frivolous" litigation); Jane Fritsch, *Securities-Bill Staff Has Ties to the Industry*, N.Y. TIMES, May 25, 1995, at A1 & B13; Anthony Lewis, *Make Haste Slowly*, N.Y. TIMES, May 15, 1995, at A17 (opposing Congress's attempt to selectively interfere with state laws).

189. See generally *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer*, No. 94-2297, 1995 U.S. App. LEXIS 3993 (7th Cir. Mar. 1, 1995), *reh'g denied*, 1995 U.S. App. LEXIS 7555 (7th Cir. Apr. 4, 1995). This dispute is typical of cases containing choice of law clauses that degenerate into a game of forum-shopping.

190. See Eric Rieder, *High Court Decisions Leave Questions Unanswered*, N.Y.L.J., Mar. 30, 1995, at 5. Other thorny issues remain as well. For example, some courts are reluctant to award attorneys' fees where the agreement is silent on this question. See *PaineWebber v. Richardson*, No. 94-3104 (S.D.N.Y. Apr. 21, 1995). Additionally, while most PDAAs contain a six year time limit provision in which to file a claim, some courts nevertheless claim jurisdiction over the case claiming they, not the arbitrators, are uniquely responsible for handling this matter. See Daniel Wise, *Time Limit Issues Not Arbitrable: Broker-Purchaser Agreements Interpreted*, July 3, 1995, at 1; Gary Spencer, *State Role in Securities Arbitrations Defined*, N.Y.L.J., Feb. 22, 1995, at 1. Lastly, one New York court has considered whether there is even personal jurisdiction over the customer who lived in Florida, and whose only contact with New York was the filing of a request to arbitrate.

There are also some real and continuing problems that must be addressed not in court, but at the contracting and transactional phases of the parties' relationship. It is almost as if this conflict between investors and brokers is institutionalized, and clauses highly favorable to one party do much to foster mistrust and misunderstanding by the other party. Until such matters are resolved, securities arbitration disputes over punitive damages and other questions will waste a great deal of time and resources.

Securities industry opposition to punitive damages runs high at the present time, but if their business practices were more sound, would this not lessen their exposure, and *a fortiori*, their opposition to punitive damages?¹⁹¹ The SEC has recently issued a report detailing such problems inherent in the industry. Indeed, SEC Chair Arthur Levitt, Jr. said: "The perception is strong that compensation practices create conditions that foster abuse."¹⁹² When brokers are paid sales commissions, it creates an incentive for brokers to churn customers' accounts, perhaps without having due regard for net return to the customer. The SEC's report offered recommendations for better ways of aligning the interests of the investor with those of the broker and firm.¹⁹³ Such recommendations, in theory, make punitive damages a secondary issue, a symptom of the real issue of egregious misconduct perpetrated by brokers and their firms. Also, to a lesser extent, the lack of responsibility by investors who need to be more vigilant has added to this situation. To make punitive damages awards the flashpoint is to miss the real problem.

A final matter that remains after *Mastrobuono* relates to whether a punitive damages award in a securities arbitration dispute may be regarded as so excessive as to violate the Fourteenth Amendment's Due Process Clause. Recall, in Part II of this Article, an award could be held so excessive that it constitutes an arbitrary deprivation of property.¹⁹⁴ An award will be upheld if there are sufficiently definite and meaningful constraints to ensure that an arbitrator's decision is made in a meaningful and deliberate manner. The stakes are higher in a case where arbitral punitive damages have been awarded because of the extremely limited grounds that exist for challenging an arbitration decision.¹⁹⁵

Two approaches show the most promise in resolving appeals of arbitrators' awards.

See Cerisse Anderson, *N.Y. Courts Powerless to Stay Out-of-State Arbitrations*, N.Y.L.J., Feb. 24, 1995, at 1.

191. See Constantine N. Katsoris, *Should McMahon be Revisited?*, 59 BROOK. L. REV. 1113, 1141-53 (1993). See generally Susan Antilla, *One Client That Wall Street Regrets*, N.Y. TIMES, Sept. 26, 1994, at D1.

192. Peter Truell, *Changes Sought in Brokers' Pay Policies*, N.Y. TIMES, Apr. 11, 1995, at D6. See generally Susan Antilla, *When It's Your Word Against Your Broker's*, N.Y. TIMES, Aug. 13, 1995, § 3 (Money and Business), at 3; Susan Antilla, *Brokerage Firms Steer Dissatisfied Customers Away From Court, But in Only One Direction*, N.Y. TIMES, May 12, 1995, at A29 (questioning fairness of 'self-regulatory' arbitration); Susan Antilla, *For the Fee-Hungry, Stars Are a Banquet*, N.Y. TIMES, Apr. 2, 1995, § 3 (Money and Business), at 4.

193. U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES (April 10, 1995); see also Micahel Siconolfi, *Revised Rules Are Mapped for Securities Arbitration*, WALL ST. J., Nov. 11, 1995, at C1; Leah Nathans Spiro & Michael Schroeder, *Can You Trust Your Broker?*, BUS. WEEK, Feb. 20, 1995, at 70-76.

194. See *supra* notes 73-90 and accompanying text.

195. See *Kelley v. Michaels*, No. 94-5023, 1995 U.S. App. LEXIS 16782, at *14-15 (10th Cir. July 10, 1995) (considering, then rejecting, brokers' due process challenge to punitive damages award); 9 U.S.C. § 10 (1994); Brian N. Smiley, *Stockbroker - Customer Disputes: Making a Case for Arbitration*, 23 GA. ST. B.J. 195 (1987).

First, it is possible to amend the FAA and lessen the currently rigorous standard of review. Grounds for review are so limited presently that there must be evidence of a manifest disregard for the law before a court may vacate an arbitrator's decision. This rule of review for arbitral decisions is in sharp contrast to the less rigorous *de novo* standard of review in which the court merely "stands in the shoes of the [trial] court."¹⁹⁶ Under the former standard, the appellate court begins its analysis with a presumption in favor of the arbitral decision, under the latter it does not. In limited instances, the *de novo* standard is used to review arbitration decisions.¹⁹⁷ To the extent that review of arbitral awards of punitive damages is altered, allowing for more judicial scrutiny, the risk of violating the Due Process Clause is lessened. However, one has to wonder if the means to this end are desirable.

Second, it is possible to further formalize the procedures for awarding punitive damages in arbitration by requiring the arbitrators to issue written opinions. Formalizing and unifying procedures will greatly reduce the risk of an arbitrary, erroneous deprivation of property without due process of law.¹⁹⁸ When a written decision is rendered that explains the reasons for awarding damages, including the procedures used for reaching the result and the formula used for the calculations, the risk of an erroneous decision is lessened.¹⁹⁹ This also obviates the need for an appeals court to make a more searching review of the arbitration procedure.

There is also the possibility of bifurcating the arbitration proceeding and considering punitive damages issues in a judicial, rather than arbitral forum. This is, however, an ill-considered approach to the problems because it would undermine the entire process of arbitration.

Finally, it may be desirable to set a maximum allowable punitive damages award. Conditions could be specified and if an award is deemed merited, arbitrators could award up to, for example, three times the compensatory damages.²⁰⁰ This somewhat standardizes awards by limiting the arbitrators' discretion, and will not as readily offend the Due Process Clause.

Under these approaches, the due process problems of excessive punitive damages are ostensibly solved, but at what price? Under the first theory the FAA is diluted and the courts' power is strengthened. Under the second theory, the FAA and the courts' roles remain relatively the same, but the arbitrators' roles are expanded and more is demanded of them. If securities and commercial arbitration are to remain viable forums for alternative dispute resolution (ADR), the problem of excessive punitive damages must be

196. *First Options of Chicago, Inc. v. Kaplan*, 19 F.3d 1503, 1509 (3d Cir. 1994) (quoting *Mutual Fire, Marine, & Inland Ins. Co. v. Norad Reins. Co.*, 868 F.2d 52, 56 (3d Cir. 1989)).

197. *Compare Kaplan*, 19 F.3d at 1509 (Third Circuit restated that its present standard of review, *de novo*, is used in considering trial court's denial of motion to vacate a commercial arbitration award.) with *Robbins v. Day*, 954 F.2d 679, 681-82 (11th Cir.), *cert. denied*, 113 S. Ct. 201 (1992) (Eleventh Circuit reviewed decisions denying petitions to vacate award using manifest disregard for the law standard.).

198. *See Katsoris*, *supra* note 191, at 1132-37.

199. *Id.* at 1140-41; Christopher F. Wilson, *Punitive Damages in Securities Arbitrations*, 26 *Sec. & Comm. Reg.* 203-09 (Nov. 24, 1993); Stewart, *supra* note 5, at 365-67.

200. *See supra* notes 9, 43; *see also Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981) (comparing punitive damages awards calculations).

solved. It remains to be seen, however, whether the solution will lead to further problems by increasing the time and money required for arbitration.²⁰¹ One of the goals, of course, for any ADR technique, is to reduce both the time and expense it takes to resolve the parties' legal claims. If securities arbitration becomes as expensive and time consuming as litigation then the value of the technique is lost. Increasing the layers of procedure and protection in arbitrators' decision-making stages may add time and expense, unless the whole system is restructured, streamlined and made uniform throughout the securities industry.

CONCLUSION

The Court has taken many opportunities to reaffirm its expansive reading of the FAA. It has perhaps taken an equal number of opportunities, to consider when punitive damages awards may offend the Due Process Clause. Securities arbitrators have had to navigate their way between choice of law clauses and arbitration forum rules, and will have to continue to do so, barring more definitive decisions by the SEC, the SROs, Congress, or the courts. Punitive damages must be available as a remedy in securities arbitration. Relief granted by arbitrators must be congruent with relief available in court. Courts are being asked too frequently to intervene in securities arbitrations. Punitive damages must never be considered waived absent clear evidence of an affirmative intent to do so. For punitive damages awards to withstand constitutional due process challenges, more detailed procedures must be added to ensure that they are the product of reasoned decision-making and that there are meaningful constraints on arbitrators' discretion. Finally, because securities arbitration is a contractually agreed upon process, every care must be taken to draft the document in such a way as to allocate risk fairly and to ensure that it represents the complete intent of *both* parties. The investor must take responsibility for being fully informed of the force and effect of all clauses. The broker and the securities firm are responsible for managing investors' funds in a way that maximizes investors' returns using appropriate investments, while minimizing self-dealing and other conflicts of interest. Fairness, and the perception of fairness are requisite elements for the continued legitimacy of the securities arbitration system.

201. See GAO REP'T, *supra* note 106, at 43, 64-65; Stewart, *supra* note 5, at 366-67 (concluding that arbitration has come to resemble litigation system it was meant to replace); Jerry Knight, *NASD to Offer Mediation for Broker-Investor Fights*, WASH. POST, July 23, 1995, at H05; *Mediation Offered to Settle Securities Disputes*, REUTERS LTD., July 20, 1995, available in LEXIS, News Library, CURNWS File (citing SECs approval of new mediation rules); Susan Antilla, *The Next Magic Bullet? Mediation*, N.Y. TIMES, Feb. 5, 1995, § 3 (Business), at 13 (citing NASD support for mediation of securities disputes as an alternative to ever-more complex arbitration system).