COMMENTS

THE DESIRABILITY OF PUNITIVE DAMAGES IN SECURITIES ARBITRATION: CHALLENGES FACING THE INDUSTRY REGULATORS IN THE WAKE OF *MASTROBUONO*

PETER M. MUNDHEIM†

INTRODUCTION

In 1985, an assistant professor of Medieval Literature at the University of Illinois at Chicago, Antonio Mastrobuono, and his wife, Diana Mastrobuono, entrusted all of their savings to Nick DiMinico, a vice-president and representative of Shearson Lehman Hutton, Inc. (Shearson).¹ DiMinico was hired to manage their money in a brokerage account.² After just two years, DiMinico squandered a substantial part of the Mastrobuonos' investment.³ In 1989, the Mastrobuonos charged that Shearson and DiMinico "subjected [their account] to unauthorized trading, churning,⁴ and margin exposure."⁵ Pursuant to the customer agreement between

† A.B. 1992, Duke University; J.D. Candidate 1996, University of Pennsylvania. I would like to thank my father, Robert H. Mundheim, Professor A. Leo Levin, James A. Keller, Siobhan McCleary, Scott K. Milsten, Pamela B. Reichlin, and Margaret E. Stowers for their contributions to this Comment. I am also grateful to my family and friends, whose encouragement and patience have guided me through law school.

¹ See Petitioner's Brief at 3-5, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995) (No. 94-18) [hereinafter Petitioner's Brief].

² In a typical brokerage account, an investor will purchase securities through a broker, often requesting advice from the broker about which securities to buy and which to sell. Occasionally, the investor will authorize the broker to trade securities on her behalf without her prior consent to each trade.

³ See Petitioner's Brief, *supra* note 1, at 6.

⁴ Churning is a type of broker fraud whereby the broker "carries out a series of purchases and resales [on the customer's behalf] that are excessive in both size and frequency, thus inflating the brokerage commission." Michael S. Wilson, *Punitive Damages in the Arbitration of Securities Churning Cases*, 11 REV. LITIG. 137, 139 (1991). Brokers typically charge a commission each time they execute a trade in a customer's account.

⁵ *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 812 F. Supp. 845, 846 (N.D. Ill. 1993) (footnote added), *aff'd*, 20 F.3d 713 (7th Cir. 1994), and *rev'd*, 115 S. Ct. 1212 (1995).

Shearson and the Mastrobuonos, an arbitration panel of the National Association of Securities Dealers (NASD) heard the complaint against Shearson and ultimately awarded the Mastrobuonos \$159,327 in compensatory damages and \$400,000 in punitive damages.⁶

In vacating the punitive damage award, the United States District Court for the Northern District of Illinois ruled that, according to the terms of the agreement, the arbitrators did not have the authority to award it.⁷ The United States Court of Appeals for the Seventh Circuit affirmed,⁸ effectively stripping the Mastrobuonos of close to seventy-five percent of their award. The Seventh Circuit reasoned that, by including a clause providing that New York law would govern the agreement, the parties manifested their intent to subject the authority of the arbitrators to any constraints placed on them by New York law⁹—and New York law, as established in *Garrity v. Lyle Stuart, Inc.*, prohibits arbitrators from awarding punitive damages.¹⁰

Undoubtedly, Shearson was elated by the Seventh Circuit's ruling, as brokerage firms would like to exclude punitive damages from arbitration altogether. In holding that a New York choice-of-law clause foreclosed the arbitrators' ability to award punitive damages, the Seventh Circuit made it simple for brokerage firms to avoid the possibility of such sanctions. Even before the Seventh Circuit's decision in *Mastrobuono*, many firms included a New York choice-of-law clause in their pre-dispute arbitration agreements.¹¹ They relied on the decision in *Garrity* and the position of courts like the Seventh Circuit to exclude, in effect, punitive damages as a remedy.¹²

The Mastrobuonos successfully challenged this tactic, however, before the United States Supreme Court.¹³ They argued, and the

⁶ See *id.*

⁷ See *id.*

⁸ See *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 715 (7th Cir. 1994), *rev'd*, 115 S. Ct. 1212 (1995).

⁹ See 20 F.3d at 717.

¹⁰ See *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976) (holding that an author could not collect punitive damages from her publisher because they were awarded by an arbitrator); see also *infra* part III.C for a more complete analysis of *Garrity*.

¹¹ See C. Evan Stewart, *Punitive Damages in Arbitration*, N.Y. L.J., July 21, 1994, at 1, 4.

¹² See *id.*

¹³ *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995).

Court agreed, that the New York choice-of-law clause does not dictate the arbitrators' ability to award punitive damages.¹⁴ In a narrowly tailored decision, the Court held that it was not clear from the wording of the customer agreement between the Mastrobuonos and Shearson¹⁵ whether New York decisional law, and thus *Garrity*, was intended to govern the authority of the arbitrators to grant remedies.¹⁶ The Court relied almost exclusively on the ambiguity of the actual agreement to reach its decision and did not speak to broader issues such as the potential inequity of limiting the remedies available to customers or, on the other hand, the problems with allowing arbitrators to award punitive damages.¹⁷ As a result, the fundamental question whether arbitrators should be permitted to award punitive damages in securities cases remains open. Now the agencies that regulate the securities industry must answer this question.

The regulatory agencies, primarily the NASD and the Securities Exchange Commission (SEC) have the authority to promulgate rules governing the arbitration process, including the types of awards that can be granted.¹⁸ These agencies will seek to compel punitive damages in arbitration only if they believe punitive damages serve

¹⁴ See Petitioner's Brief, *supra* note 1, at 42-43 (citing *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988), which held that a choice-of-law clause only dictates the substantive law that arbitrators must apply).

¹⁵ The agreement stated, in relevant part:

This agreement shall inure to the benefit of your [Shearson's] successors and assigns[,] shall be binding on the undersigned, my [petitioners'] heirs, executors, administrators and assigns, and shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [my] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I may elect. If I do not make such election by registered mail addressed to you at your main office within 5 days after demand by you that I make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof. This agreement to arbitrate does not apply to future disputes arising under certain of the federal securities laws to the extent it has been determined as a matter of law that I cannot be compelled to arbitrate such claims.

Mastrobuono, 115 S. Ct. at 1216 n.2 (alterations in original).

¹⁶ See *id.* at 1217.

¹⁷ See *id.* at 1216-18.

¹⁸ See Interview with Deborah Masucci, Vice-President and Director of Arbitration, National Association of Securities Dealers, in New York, N.Y. (Jan. 3, 1995) [hereinafter Masucci Interview].

an important function in the securities industry. In forming their opinion, the agencies must consider the functions punitive damages are designed to serve and whether they successfully serve those functions in securities arbitration. In addition, the constitutional requirements of due process may mean that punitive damages can only be awarded under certain circumstances.¹⁹ If punitive damages are to become a fixture in securities arbitration, the agencies must address the due process requirements.

This Comment argues that punitive damages are a necessary component of arbitration in the securities industry, but that, given the requirements of due process, arbitrators should be constrained in their ability to make such awards. To develop this argument, the Comment is divided into four parts. Part I chronicles the evolution of arbitration in the securities industry and summarizes the legal debate that developed in the courts regarding whether to uphold or vacate punitive damage awards by arbitrators. Part II analyzes the Supreme Court's decision in *Mastrobuono* and concludes that the ultimate question whether punitive damage awards should be available in securities arbitration has been left to the industry regulators. Part III explores the purposes of punitive damages and argues that they are vital to the legitimacy of arbitration as the primary method of dispute resolution in broker-customer cases and that they aid in policing the conduct of brokerage firms. In addition, Part III discusses the public policy concerns and the constitutional limitations on arbitrators' authority to award punitive damages. Finally, Part IV advocates a change in the current procedure for awarding punitive damages in securities arbitration which meets the constitutional requirements of due process while enabling punitive damages to serve important functions.

I. THE EVOLUTION OF THE DISPUTE OVER THE ROLE OF PUNITIVE DAMAGES IN SECURITIES ARBITRATION

A. *The Increasing Use of Mandatory Arbitration Agreements*

Today, disputes between brokerage firms and their customers are typically resolved through arbitration. Brokerage firms have increasingly compelled their customers to sign arbitration agreements as a precondition to opening an account.²⁰ The move

¹⁹ For a discussion of the due process requirements involved in arbitral awards of punitive damages, see *infra* notes 216-38 and accompanying text.

²⁰ See Constantine N. Katsoris, *Should McMahon Be Revisited?*, 59 BROOK. L. REV.

toward mandatory arbitration agreements began in 1987 on the heels of the Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*.²¹ In *McMahon*, the Court declared that it is the policy of the federal courts to "rigorously enforce agreements to arbitrate."²² The decision in *McMahon* signaled that brokerage firms could require customers to agree to settle their disputes in arbitration. This legal development led to a dramatic rise in the number of securities arbitration cases. In 1980, 830 securities arbitration cases were filed with the self-regulatory organizations (SROs),²³ and that number rose to 5300 cases in 1993.²⁴ The overwhelming number of cases are brought by investors against brokerage firms.²⁵

1113, 1131-32 (1993). Upon joining a brokerage firm, employees must also agree to resolve disputes through arbitration; however, this Comment addresses only those issues raised by broker-customer agreements.

²¹ 482 U.S. 220 (1987); see also Anthony M. Sabino, *Awarding Punitive Damages in Securities Industry Arbitration: Working for a Just Result*, 27 U. RICH. L. REV. 33, 34 (1992) ("[The FAA] was intended to 'revers[e] centuries of judicial hostility to arbitration agreements . . .'" (quoting *McMahon*, 482 U.S. at 225 (second alteration in original))); George H. Friedman, *Changes in Rules on Securities Cases*, N.Y. L.J., Aug. 5, 1993, at 3, 28 (citing *McMahon* as the starting point of arbitration's popularity increase).

²² *McMahon*, 482 U.S. at 226 (quoting *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985)).

²³ See GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 18 (1992) [hereinafter GAO]. SROs are the internal organizations in the securities industry that are responsible for overseeing the conduct of the brokerage firms. Conducting arbitration proceedings is among their duties. The SROs include the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers. The NASD hears the bulk of the broker-investor arbitration cases. See J. Stratton Shartel, *Attorneys Describe Diverse Strategies in Securities Arbitration*, INSIDE LITIG., May 1994, at 1, 1. In 1980, for example, 318 of the 840 arbitration claims filed were handled by the NASD. See *id.* In 1993, the NASD handled over 5000 arbitration cases. See *id.*

The American Arbitration Association (AAA) is an independent arbitration body which also hears securities cases. However, most firms do not offer their customers with margin or options accounts the opportunity to bring their disputes to AAA forums. See GAO, *supra*, at 32. The firms may limit the use of AAA arbitration forums because they are generally more expensive than SRO forums and the firms do not consider the AAA arbitrators to be as knowledgeable as SRO arbitrators about issues unique to the securities industry. See Masucci Interview, *supra* note 18.

²⁴ See Susan Antilla, *An Arbitration Plan Goes Begging*, N.Y. TIMES, Jan. 9, 1994, at 15.

²⁵ See Shartel, *supra* note 23, at 1. For example, of the 1604 securities cases arbitrated in 1993, 1329 were "customer cases," meaning that a customer filed a complaint against a brokerage firm. See *id.*

B. *The Benefits of Arbitration in Securities Cases*

Brokerage firms and their customers benefit when certain disputes are resolved in arbitration rather than in court for several reasons.²⁶ First, in theory, arbitration is faster than litigation.²⁷ The average securities arbitration case heard in an SRO forum lasts 383 days from the time the investor's claim is filed until the arbitrators notify the parties of their decision.²⁸ Second, costs in arbitration are relatively low because forum filing fees are reasonable and investors are not required to be represented by counsel.²⁹ Third, arbitrators' rulings are rarely overturned, thus rendering the arbitrators "final" decisionmakers. While their decisions may be appealed to a trial court, they are only overturned if "the arbitrators exceeded their powers."³⁰ This is a difficult standard to meet because there is typically no written opinion in a securities arbitration case.³¹ The narrow scope of judicial review coupled with the

²⁶ Not all brokerage customers must sign arbitration agreements. Customers who open cash accounts (where the investor purchases securities without an extension of credit and receives cash for securities sold) normally do not have to agree to settle disputes with the firm through arbitration. In fact, only one out of nine of the largest brokerage firms required an arbitration agreement for cash accounts; however, 46% of medium size firms and 37% of small firms did require arbitration agreements for cash account customers in 1990. See GAO, *supra* note 23, at 28. In contrast, all of the large firms, 90% of the medium firms, and 70% of the small firms required arbitration agreements for margin accounts (where the broker-dealer may extend credit to the investor for up to 50% of the purchase price of the securities) and options accounts (where the investor may purchase the right to buy or sell securities on a specific date). See *id.* Disputes relating to options and margin accounts usually involve more technical and complex issues and subject the firm to more substantial risk than those involving cash accounts. Arbitration is favored for these types of accounts because the arbitrator is often familiar with the issues and because "margin and options accounts are more likely to result in litigation . . . [making] . . . arbitration, as the less costly forum, . . . particularly appropriate for these types of accounts." *Id.* at 33 (quoting testimony of David Ruder, SEC Chairman, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, July 12, 1988).

²⁷ However, the GAO study stated that it is not practical to compare the time or cost savings of broker-customer arbitration with litigation of these disputes because very few cases are actually litigated. See GAO, *supra* note 23, at 35. Furthermore, those that are scheduled to be litigated are often settled, and very little information is available about the terms of the settlement. See *id.*

²⁸ See *id.* at 44.

²⁹ The forum filing fees in an SRO arbitration of a \$40,000 claim are \$520 for the first session; for a claim of \$5000 or less the fee is \$125. See *id.* at 47. More importantly, 42% of the investors in SRO arbitrations in 1990 were not represented by counsel, significantly trimming the overall cost of arbitration. See *id.* at 40.

³⁰ Federal Arbitration Act, 9 U.S.C. § 10(a)(4) (1994) (establishing the standard for judicial review of arbitration awards).

³¹ See C. Evan Stewart, *Securities Arbitration Appeal: An Oxymoron No Longer?*, 79

difficulty of demonstrating that an arbitrator has overstepped his bounds operate to make arbitrators' decisions final. The practical finality of arbitrators' decisions reduces the incentive of the losing party to appeal, thereby benefitting both parties by avoiding costly additional litigation. Fourth, many of the arbitrators who hear securities cases have expertise in, or at least familiarity with, the disputed issues.³² Armed with a more complete understanding of the case, they can render a more informed judgment, which is particularly beneficial in complex cases.

Brokerage firms gain an additional benefit from arbitration because these proceedings often receive less publicity than trials. As previously noted, no opinions are written or published, although the results of most arbitration hearings are publicly available. Minimizing publicity is particularly important for brokerage firms because they stand to lose business if their reputations are tarnished in the eyes of the public.³³

C. *How Arbitrators' Punitive Damage Awards Become the Subject of Litigation*

Arbitration cases most often begin when an investor charges a brokerage firm with some form of misconduct. The three most frequent allegations in securities claims are misrepresentation of the

KY. L.J. 347, 363 (1990-91) (noting that it is difficult to apply the "manifest disregard of the law" standard of review without a written opinion). However, there is almost always a record of the proceedings. The New York Stock Exchange, for example, mandates that a "verbatim record of all arbitration hearings . . . be kept by stenographic reporter or tape recording." See New York Stock Exchange, Inc., *Arbitration Rules* Rule 623, in N.Y.S.E. Guide (CCH) ¶ 2623 (1995). At the discretion of the parties the recording may be done with a simple tape recorder, or the parties may hire a stenographer to create a written transcript of the proceedings. In cases where high dollar amounts are at stake, the parties will typically invoke more sophisticated means of recording. A written transcript is more valuable to the parties if the judgment of the arbitrators is appealed because the appellate body will be able to evaluate the evidence presented in the arbitration proceeding more easily. See Masucci Interview, *supra* note 18.

³² In SRO arbitrations, the Uniform Code of Arbitration Procedures dictates that, in a customer dispute involving more than \$10,000 (\$30,000 in NASD arbitrations), two of the three arbitrators be "public arbitrators," meaning that they have no connection to the industry. See GAO, *supra* note 23, at 55. However, the third arbitrator is often an "industry arbitrator," meaning one who has some background or involvement with the industry. See Masucci Interview, *supra* note 18. In cases involving less than \$10,000 (\$30,000 in NASD arbitrations), one public arbitrator is generally required. See GAO, *supra* note 23, at 40. See *infra* note 190 for a more complete definition of "industry arbitrator."

³³ See Masucci Interview, *supra* note 18.

risk of an investment by the broker, negligence in managing an investor's portfolio, and unauthorized trading in the investor's account.³⁴ Very often, customers will assert one of these charges against the individual broker and additionally charge the broker's firm with breach of fiduciary duty or negligence for failing to properly supervise the activities of its employees.³⁵ In all but approximately two percent of the cases actually arbitrated, the arbitration panel grants only compensatory damages.³⁶ However, in cases of particularly egregious misconduct, arbitrators also award punitive damages against the firm.³⁷

Prior to *Mastrobuono*, punitive damage awards often became the subject of litigation, particularly if the customer agreement specified that New York law governed. As previously noted, arbitrators cannot award punitive damages under New York law.³⁸ Therefore, brokerage firms resisted paying punitive damage awards imposed by arbitrators where the customer agreement contained a New York choice-of-law clause. The firms believed that in these cases the arbitrators had no authority under the terms of the agreement to make such awards. Their resistance resulted in litigation in one of two ways: (1) if the arbitrators had already awarded the investor

³⁴ See GAO, *supra* note 23, at 43.

³⁵ See, e.g., *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 715 (7th Cir. 1994) (stating that the broker was charged with unauthorized trading, churning, and margin exposure and that a breach of fiduciary duty and negligence was also asserted against Shearson), *rev'd*, 115 S. Ct. 1212 (1995); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1380 (11th Cir. 1988) (upholding a punitive damage award against Dean Witter after the investors alleged negligence, breach of fiduciary duty, and gross negligence in the handling of their account); *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 828, 832 (Ct. App. 1993) (upholding an arbitration panel's punitive damage award against J. Alexander Securities for account churning and fraud by the broker and breach of obligation to supervise its employees), *cert. denied*, 114 S. Ct. 2182 (1994).

³⁶ See *Punitive Award Survey*, SEC. ARB. COMMENTATOR, May 1993, at 1, 7 (reporting that punitive damages were awarded in 147 of 6870 cases arbitrated between May 1989 and June 1992) [hereinafter *Punitive Award Survey*].

³⁷ It seems probable that the fear of a punitive damage award causes firms to settle many customer disputes instead of arbitrating them. See Masucci Interview, *supra* note 18. In two of the three cases cited earlier, see *supra* note 35, the arbitration panel assessed the punitive damage award against the brokerage firm, rather than against the individual broker. This result may indicate that arbitrators wish to provide firms with an incentive to supervise their brokers more closely in the future, in addition to merely punishing them. It is also possible that the punitive damage awards were assessed against the brokerage firms because of their ability to pay. See *infra* part III.A.2-3 for further discussion of the motivations for assessing punitive damage awards against brokerage firms.

³⁸ See *supra* note 10 and accompanying text.

punitive damages and the brokerage firm had refused to pay, the investor sought enforcement of the arbitrators' judgment in court³⁹ or (2) the brokerage firm appealed the arbitrators' award directly pursuant to § 10(a)(4) of the Federal Arbitration Act (FAA),⁴⁰ claiming that the arbitrators exceeded their powers and that, therefore, the punitive damage award should be vacated.⁴¹

The lower courts had taken different positions on the effect of a New York choice-of-law clause on the authority of arbitrators to grant remedies. The *Mastrobuono* case provided the Supreme Court the opportunity to settle this debate and, additionally, to announce its views on the legality and desirability of awarding punitive damages in arbitration. It did not. Instead, the Court crafted an opinion that addressed only the specific customer agreement before it, leaving both the legal issues raised by the lower courts and the public policy concerns discussed by commentators unresolved.⁴²

*D. The Historical Debate over How to Interpret the
Intent of the Parties Regarding the Authority
of Arbitrators to Award Punitive Damages*

As previously noted, the cases in which parties have sought to enforce or vacate arbitrators' punitive damage awards, arising out of arbitration agreements containing New York choice-of-law clauses, had been decided inconsistently by the courts. Two lines of thought had emerged among the federal appellate courts: courts following the "propunitive" position upheld arbitrators' punitive damage awards⁴³ while those following the "antipunitive" position consistently vacated punitive damage awards made by arbitrators.⁴⁴

³⁹ See, e.g., *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 118 (2d Cir. 1991) (noting that the district court had confirmed the arbitrators' award of punitive damages at the request of the investors).

⁴⁰ 9 U.S.C. § 10(a)(4) (1994).

⁴¹ See, e.g., *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1381 (11th Cir. 1988) (noting that Dean Witter first petitioned the district court to vacate the punitive damage award).

⁴² See *infra* notes 88-103 and accompanying text for a detailed analysis of the Supreme Court's opinion in *Mastrobuono*.

⁴³ The propunitive position was supported primarily by the First, Eighth, Ninth and Eleventh Circuits. See, e.g., *Lee v. Chica*, 983 F.2d 883, 888 (8th Cir.) (upholding arbitrators' punitive damage award), *cert. denied*, 114 S. Ct. 287 (1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1063 (9th Cir. 1991) (same); *Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6, 12 (1st Cir. 1989) (same); *Bonar*, 835 F.2d at 1387 (11th Cir. 1988) (same).

⁴⁴ The antipunitive position was supported primarily by the Second and Seventh

Both positions interpreted the arbitration agreements as if they were standard contracts. This contractual analysis focused the court's inquiry on the intent of the parties to the agreement. The United States Supreme Court unmistakably endorsed this contractual approach in *Volt Information Sciences v. Board of Trustees*,⁴⁵ stating that "the FAA's primary purpose . . . [is to] ensur[e] that private agreements to arbitrate are enforced according to their terms."⁴⁶ The *Volt* Court explicitly emphasized the supremacy of the parties' intent, maintaining that, although the FAA endorses arbitration, it "does not require parties to arbitrate when they have not agreed to do so."⁴⁷

The conflict between the circuits arose when the courts attempted to determine, under this contractual analysis, whether the parties did in fact intend to allow the arbitrators to award punitive damages. Predictably, the broker-dealers insisted that the arbitration agreements did not contemplate punitive awards, while customers maintained that they did. The central point of debate was whether the parties intended the New York choice-of-law clause to govern the arbitrators' ability to fashion remedies. If the parties intended the clause to govern remedies, then arbitrators could not make punitive damage awards because New York law prohibits them.⁴⁸ If not, the courts had to look to other indicators in the agreement to determine the parties' intentions regarding the scope of the arbitrators' authority.

Circuits. See, e.g., *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 719 (7th Cir. 1994) (vacating arbitrators' punitive damage award), *rev'd*, 115 S. Ct. 1212 (1995); *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 118 (2d Cir. 1991) (same).

⁴⁵ 489 U.S. 468 (1989).

⁴⁶ *Id.* at 479. *Volt* and Leland Stanford Junior University entered into a construction contract that provided that the contract would be governed by the law of "the place where the Project [wa]s located" (California). See *id.* at 470. During the performance of the contract, a dispute arose regarding compensation for additional work that needed to be performed. Stanford brought suit for breach of contract in a California Superior Court. *Volt* responded by petitioning the court to compel arbitration. See *id.* at 470-71. The question facing the Supreme Court was whether the choice-of-law clause in the contract meant that California's state arbitration rules governed. Under California law, arbitration can be stayed pending the resolution of a related litigation. See *id.* at 470. The Court stated that because the parties agreed to be bound by California law, as evidenced by the choice-of-law clause, the California rule would govern unless it came into direct conflict with federal law. See *id.* at 479.

⁴⁷ *Id.* at 478.

⁴⁸ See, e.g., *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976) (establishing that arbitrators cannot award punitive damages as a matter of public policy).

1. The Propunitive Analysis

The propunitive courts held that a New York choice-of-law clause does not, by itself, prohibit arbitrators from awarding punitive damages.⁴⁹ Instead, they maintained that the choice-of-law clause provides the substantive law governing the agreement.⁵⁰ In other words, the arbitrators should apply New York law to determine whether the broker or the firm committed acts that deserve a punitive sanction, but not to determine the scope of power of the arbitrators. The propunitive courts grounded this conclusion in their analysis of the particular arbitration agreement.

First, the propunitive courts studied the contract between the parties to determine if it "evidenced a transaction in interstate commerce."⁵¹ If it did, the agreement was subject to the FAA.⁵² In *Southland Corp. v. Keating*,⁵³ the Supreme Court held that the FAA applies to the states via the Commerce Clause.⁵⁴ Because "most securities cases do in fact involve an element of interstate commerce," the FAA usually applies.⁵⁵ The First Circuit summarized a court's duty under the FAA, stating that "the specific question we must answer" is whether the parties, when they "agreed to 'settle' through arbitration 'all disputes' . . . and to authorize the arbitrator to grant any just and equitable remedy or relief, agreed to include 'within the terms of [their] agreement' the power to award punitive damages."⁵⁶

⁴⁹ See, e.g., *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988) (holding that a New York choice-of-law clause does not speak to the authority of the arbitrators to award punitive damages); *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 830 (Ct. App. 1993) ("The choice of law provision, therefore, merely designates the substantive law that the arbitrators must apply . . . it does not deprive the arbitrators of their authority to award punitive damages." (citations omitted)), cert. denied, 114 S. Ct. 2182 (1994); cf. *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062 (9th Cir. 1991) (rejecting the argument that a choice-of-law clause in an arbitration agreement automatically dictates that that state's arbitration rules apply).

⁵⁰ See, e.g., *Bonar*, 835 F.2d at 1387; *Mendez*, 21 Cal. Rptr. 2d at 830.

⁵¹ *Bonar*, 835 F.2d at 1387.

⁵² See *id.*

⁵³ 465 U.S. 1 (1984).

⁵⁴ See *id.* at 12.

⁵⁵ Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, 586 (1991).

⁵⁶ *Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6, 10 (1st Cir. 1989) (fourth alteration in original). In *Bonar*, the Eleventh Circuit also suggested that the intent of the parties ultimately controls the authority of the arbitrators. See *Bonar*, 835 F.2d at 1387 n.16 ("Of course, the [Federal] Arbitration Act would not override a clear provision in a contract prohibiting arbitrators from awarding punitive damages."); see

The first place the propunitive courts looked to discover the parties' intent was the choice-of-law clause. It would seem that by incorporating a New York choice-of-law clause, the parties desired that the agreement be construed according to the laws of New York, which, as mentioned, prohibit arbitrators from awarding punitive damages as a matter of public policy.⁵⁷ The propunitive courts avoided this apparent result, however, reasoning that the Supreme Court in *Volt* created a distinction between substantive and procedural rules and that the choice-of-law clause only signaled the parties' intent to submit to the state's *substantive* rules.⁵⁸ One court maintained, for example, that "a choice of law provision in a contract governed by the [Federal] Arbitration Act merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages,"⁵⁹ but does not govern the types of remedies that the arbitrators can grant.⁶⁰ The distinction made by this court suggests that the holding in *Garrity* was not substantive state law, but rather simply state arbitration law or procedural law and, therefore, not relevant to a determination of the scope of the arbitrators' authority.⁶¹

The propunitive courts' interpretation of *Volt* and *Garrity* forced them to look at indicators other than the choice-of-law clause to glean whether the customer agreement contemplated granting arbitrators the power to award punitive damages. The propunitive courts consistently found evidence that it did. This evidence came from analyzing the arbitration clause used in the agreement and the arbitration forum chosen by the parties as well as from applying the broad principles of the FAA.

also *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 830 (Ct. App. 1993) (noting that "[f]ederal policy supports vesting arbitrators with the authority to award punitive damages if the parties' agreement contemplates such an award"), *cert. denied*, 114 S. Ct. 2182 (1994).

⁵⁷ See *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976) (vacating arbitrators' award of punitive damages on the grounds that "[p]unitive damages is a sanction reserved to the State").

⁵⁸ See C. Evan Stewart, *Punitive Damages in Arbitration: Fish or Cut Bait*, N.Y. L.J., Feb. 21, 1991, at 5, 6 (discussing the two interpretations of the Supreme Court's holding in *Volt* and criticizing the propunitive interpretation).

⁵⁹ *Bonar*, 835 F.2d at 1387.

⁶⁰ See *id.*

⁶¹ But cf. Stewart, *supra* note 58, at 6 (criticizing this argument and stating, "the New York Court of Appeals would be somewhat surprised to know that its pronouncement of New York public policy is not considered . . . substantive state law").

Most customer agreements contain a broad statement defining the scope of arbitration. For example, one typical customer agreement provided for "arbitration of 'any dispute or controversy between [the parties] . . . arising out of [the brokerage firm's] . . . business or this agreement.'" ⁶² Concluding that the encompassing language of this agreement "seem[s] to contemplate a wide range of tort and contract claims," one court held that the agreement "contemplated punitive damages." ⁶³

In addition to considering the language of the arbitration clause, the propunitive courts considered the rules of the arbitration forum chosen by the parties. Often, the investor is given a choice between several arbitration forums such as the American Arbitration Association, the National Association of Securities Dealers, Inc., or the New York Stock Exchange. Each forum describes the authority of arbitrators to award damages in slightly different, but equally vague, language.

AAA Rule 43, which governs the scope of arbitral awards, states that arbitrators may "grant any remedy or relief" that they deem "just and equitable and within the terms of the agreement of the parties." ⁶⁴ In comparison, NASD Rules of Fair Practice section 21(f)(4) declares that "[n]o agreement shall include any condition which . . . limits the ability of the arbitrators to make any award." ⁶⁵ The applicable NYSE rule also states that "[n]o agreement shall include any condition which limits the ability of the arbitrators to make any award." ⁶⁶

Some propunitive courts interpreted the selection of an AAA forum to mean that the parties contemplated punitive damages. It

⁶² *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 828 (Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994); *see also Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6, 7 (1st Cir. 1989) (discussing an arbitration clause stating that "[a]ll disputes arising in connection with the Agreement shall be settled by arbitration" (alteration in original)); *Bonar*, 835 F.2d at 1386 (containing an arbitration clause providing that "[a]ny controversy between [Dean Witter] and [the customer] . . . arising out of or relating to this contract or the breach thereof, shall be settled by arbitration" (second alteration in original)).

⁶³ *Mendez*, 21 Cal. Rptr. 2d at 830-31; *see also Raytheon*, 882 F.2d at 10 (stating that the language of the arbitration clause is "sufficiently broad to encompass the award of punitive damages").

⁶⁴ *Raytheon*, 882 F.2d at 9-10. The court refers to the rule as Rule 42, an earlier designation for the same provision. *See id.* at 10 n.4.

⁶⁵ National Ass'n of Sec. Dealers, Inc., *Rules of Fair Practice* § 21(f)(4), in NASD Sec. Dealers Manual (CCH) ¶ 2171 (1994).

⁶⁶ New York Stock Exch., Inc., *Arbitration Rules* Rule 636(d), in N.Y.S.E. Guide (CCH) ¶ 2636(d) (1995).

is difficult to understand why these courts, but not others, interpret the AAA rule to contemplate punitive damage awards. The courts themselves have supplied very little explanation for the distinction. In *Raytheon Co. v. Automated Business Systems*, for example, the court simply quoted the phrase "any remedy or relief" from Rule 43 and concluded that it, in combination with the parties' broadly worded customer agreement, evidenced "an intention . . . to allow the chosen dispute resolvers to award the same varieties and forms of damages . . . as a court would be empowered to award."⁶⁷ The customer agreement stated, in relevant part, that "[a]ll disputes' arising from the contract 'shall be settled' through arbitration."⁶⁸ Other courts that relied, in part, on the choice of the AAA forum to conclude that the parties had contemplated punitive damages were even more conclusory than the *Raytheon* court in their reasoning. For example, the Ninth Circuit in *Todd Shipyards Corp. v. Cunard Line, Ltd.*⁶⁹ simply announced that "the expansive view that has been taken of the power of arbitrators to decide disputes, coupled with the incorporation of AAA Commercial Arbitration Rule 43 by the parties, provided the arbitration panel here with authority to make the punitive damage award."⁷⁰ No substantive explanation, however, was provided for this judicial interpretation of AAA Rule 43.

The final factor that the propunitive courts considered in concluding that the typical customer agreement empowered arbitrators to award punitive damages was the general policy of the FAA⁷¹ favoring arbitration in ambiguous cases. The courts relied on the pronouncement of the Supreme Court in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*⁷² that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."⁷³ The courts utilized *Moses H. Cone* as a "tie-breaker" that consistently favors arbitration of *all* issues. Thus, where the agreement did not make the parties' intent clear, the courts invoked *Moses H. Cone* to enable them to uphold the punitive damage award made by the arbitration panel.⁷⁴ The courts did not

⁶⁷ *Raytheon*, 882 F.2d at 9-10.

⁶⁸ *Id.* at 9.

⁶⁹ 943 F.2d 1056 (9th Cir. 1991).

⁷⁰ *Id.* at 1063.

⁷¹ 9 U.S.C. §§ 1-307 (1994).

⁷² 460 U.S. 1 (1983).

⁷³ *Id.* at 24-25.

⁷⁴ See, e.g., *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 830 (Ct. App.

use the principle of *Moses H. Cone* alone to support a ruling that punitive damages were within the scope of the agreement, but instead coupled that principle with evidence from the broad language of the arbitration clause⁷⁵ and the choice of the AAA as the forum for arbitration to reach their result.⁷⁶

2. The Antipunitive Analysis of the Parties' Intent Relies Exclusively on the Choice-of-Law Clause

As mentioned previously, the antipunitive courts did not enforce punitive damage awards stemming from arbitration agreements with a New York choice-of-law clause.⁷⁷ Although these courts recognized the liberal federal policy favoring arbitration, they refused to "rewrite the agreement to enhance arbitrability or otherwise expand the scope of the arbitrator's powers."⁷⁸ To do so, they maintained, would be inconsistent with the FAA.⁷⁹ The antipunitive courts stated simply that in these cases "the language of the parties' Agreement is clear: 'This agreement shall . . . be governed by the laws of the State of New York.'"⁸⁰ The choice-of-law clause was deemed to apply to the entire agreement, in all circumstances,

1993) (citing *Moses H. Cone* and explaining that "[f]ederal policy supports vesting arbitrators with the authority to award punitive damages if the parties' agreement contemplates such an award"), *cert. denied*, 114 S. Ct. 2182 (1994). The court later held that even though the NASD rules of arbitration used in this dispute did not address the issue of punitive damages directly, that did not mean that the arbitrators were precluded from awarding punitive damages. *See Mendez*, 21 Cal. Rptr. 2d at 832; *see also Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6, 9 (1st Cir. 1989) (noting the principle that doubts concerning the arbitrability of an issue "should be resolved in favor of arbitration" (quoting *Moses H. Cone*, 460 U.S. at 9)).

⁷⁵ *See Mendez*, 21 Cal. Rptr. 2d at 830-31.

⁷⁶ *See Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062-63 (9th Cir. 1991); *Raytheon*, 882 F.2d at 9-12; *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1386-87 (11th Cir. 1988).

⁷⁷ *See, e.g., Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 716-18 (7th Cir. 1994), *rev'd*, 115 S. Ct. 1212 (1995); *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 121-22 (2d Cir. 1991).

⁷⁸ *Mastrobuono*, 20 F.3d at 716.

⁷⁹ *See id.* at 716-17 (noting that enforcing the state rules of arbitration even though they restrict the arbitrability of certain issues is consistent with the FAA if the parties intended that result); *Barbier*, 948 F.2d at 122 (same).

⁸⁰ *Barbier*, 948 F.2d at 122 (alteration in original); *see also Mastrobuono*, 20 F.3d at 717 (finding that the "parties agreed to arbitrate all of their controversies under New York law").

including the arbitrators' authority to grant remedies.⁸¹

The antipunitive courts concluded that by selecting New York law to govern the agreement the parties manifested their intent to be bound by *Garrity*.⁸² In other words, the parties agreed that punitive damages would not be an available remedy. Therefore, any arbitral punitive damage award was overturned pursuant to § 10(a)(4) of the FAA, which provides that awards may be vacated "[w]here the arbitrators exceeded their powers."⁸³

The foregoing comparison of the approaches utilized by the lower courts identifies the sections of a customer agreement that define the parties' intent regarding the arbitrators' authority to award damages and outlines strategies for interpreting those sections. The Supreme Court in *Mastrobuono v. Shearson Lehman Hutton, Inc.*⁸⁴ considered several aspects of the agreement just as the lower courts did, but ultimately concluded that those considerations were not dispositive as to the intent of the parties regarding the scope of the arbitrators' authority to grant remedies.⁸⁵ However, due to the Court's approach, its conclusion resolved only the single question of how to interpret properly a broker-customer agreement drafted in exactly the same manner as the one between the Mastrobuonos and Shearson.

II. WHY THE SUPREME COURT'S DECISION IN *MASTROBUONO* FAILED TO SETTLE THE PUNITIVE DAMAGE DEBATE

The Supreme Court's decision in *Mastrobuono* provided the lower courts with very limited direction on the process of properly interpreting arbitration agreements and, consequently, the securities industry received little guidance on how to draft them effectively. The court only resolved the dispute over the effect of a New York choice-of-law clause on the ability of arbitrators to award punitive damages, holding that such a clause, by itself, was insufficient to deny arbitrators that power. However, the opinion suggested, but did not clearly state, that a New York choice-of-law clause, in combination with other language clearly describing its scope and

⁸¹ See *Mastrobuono*, 20 F.3d at 717-19 (rejecting arguments that the choice-of-law clause only dictates the substantive law of the agreement and that the rules of the arbitration forum govern the scope of the arbitrators' authority).

⁸² See, e.g., *Mastrobuono*, 20 F.3d at 716; *Barbier*, 948 F.2d at 122.

⁸³ Federal Arbitration Act, 9 U.S.C. § 10(a)(4) (1994).

⁸⁴ 115 S. Ct. 1212 (1995).

⁸⁵ See *id.* at 1215-16.

application, would be sufficient. Furthermore, the Court was silent on the broader public policy issue whether arbitrators in securities cases *ought to be* permitted to award punitive damages.

The Court began its analysis by stating that it viewed the agreement as a standard contract between Shearson and the Mastrobuonos. The Court cited its earlier holdings in *Volt Information Sciences v. Board of Trustees*⁸⁶ and *Southland Corp. v. Keating*⁸⁷ for the proposition that in a case such as this one, in which the FAA applies,⁸⁸ the intent of the parties, not state law, shall govern the authority of the arbitrators.⁸⁹ Having established the scope of its inquiry, the Court set out to determine "what the contract ha[d] to say about the arbitrability of petitioners' [the Mastrobuonos'] claim for punitive damages."⁹⁰ The Court looked to two particular sentences in the customer agreement to glean the parties' intent before ultimately concluding that the agreement did not clearly speak to the authority of the arbitrators to award punitive damages.⁹¹

First, the Court examined the choice-of-law clause which stated that "the entire agreement 'shall be governed by the laws of the State of New York.'"⁹² According to the Court, this clause could be interpreted either as a mere "substitute for the conflict-of-laws analysis" or as a more sweeping application of New York law.⁹³ The Court stated that if the clause was intended to be a substitute for a conflict-of-laws analysis, punitive damages would still be permitted.⁹⁴ Because the parties did not, according to the Court, manifest an intent otherwise, "the FAA would pre-empt the *Garritty* rule" and dictate that punitive damages be arbitrated.⁹⁵ On the other hand, reasoned the Court, even if the choice-of-law clause was intended to serve as more than a substitute for the conflict-of-laws

⁸⁶ 489 U.S. 468 (1989).

⁸⁷ 465 U.S. 1 (1984).

⁸⁸ The FAA applies to arbitration cases in which the parties have engaged in interstate commerce. See *supra* notes 51-54 and accompanying text.

⁸⁹ See the discussion of *Southland* and *Volt* in *Mastrobuono*, 115 S. Ct. at 1215-16 (supporting the view that the parties may agree to submit to arbitration issues such as punitive damages, even if "state law would otherwise exclude such claims from arbitration").

⁹⁰ *Mastrobuono*, 115 S. Ct. at 1216.

⁹¹ See *id.* at 1216-18.

⁹² *Id.* at 1217.

⁹³ *Id.*

⁹⁴ See *id.*

⁹⁵ *Id.*

analysis, it was not clear from the contract exactly how far to extend New York law.⁹⁶ It is plausible that New York law was meant to identify only the substantive law that governed the contract and not the "allocation of power between [courts and arbitrators]."⁹⁷ If that was the case, the punitive damage award should stand. Basing its decision upon the ambiguous purpose of the choice-of-law clause and the fact that either of these meanings could reasonably have been intended by the parties, the Court concluded that the choice-of-law clause "is not, in itself, an unequivocal exclusion of punitive damage claims."⁹⁸

Second, the Court examined the wording of the sentence in the agreement that states, "any controversy' . . . 'shall be settled by arbitration' in accordance with the rules of the [NASD]."⁹⁹ The Court noted that the NASD Code of Arbitration Procedure allows arbitrators to award "damages and other relief."¹⁰⁰ It does not specify any limitations on the types of relief that can be granted. Furthermore, the Court agreed with the analysis conducted by the First Circuit in *Raytheon* which maintained that "a contract clause which bound the parties to 'settle' 'all disputes' through arbitration conducted according to rules which allow any form of 'just and equitable' 'remedy of relief' [sic] was sufficiently broad to encompass the award of punitive damages."¹⁰¹

After discussing the choice-of-law provision and the arbitration clause separately, the Court examined them together. Together, the two provisions did not illuminate the intent of the parties any more than they did separately. Rather, they merely rendered ambiguous "an arbitration agreement that would otherwise allow punitive damage awards."¹⁰² After reasoning that the parties did not clearly express in the agreement their intentions regarding punitive damages, the Court applied standard contract principles to reach the conclusion that any ambiguities in the agreement should be construed against Shearson, the drafter.¹⁰³ Thus, the arbitrators'

⁹⁶ *See id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.* (quoting the customer agreement between Shearson and the Mastrobuenos). According to the terms of the agreement, the Mastrobuenos could have chosen to arbitrate in accordance with the NASD or the NYSE.

¹⁰⁰ *Id.* at 1218 (quoting National Ass'n of Sec. Dealers, Inc., *Code of Arbitration Procedure* § 41(e), in NASD Sec. Dealers Manual (CCH) ¶ 3741(e) (1993)).

¹⁰¹ *Id.* at 1218 n.7 (citing *Raytheon Co. v. Automated Business Sys.*, 882 F.2d 6, 10 (1st Cir. 1989)).

¹⁰² *Id.* at 1218.

¹⁰³ *See id.* at 1219. According to the *Restatement of Contracts*, "[i]n choosing among

punitive damage award was upheld.

The *Mastrobuono* decision did very little to resolve the problems raised by the lower courts regarding the interpretation of arbitration agreements. By restricting its decision to a critique of Shearson's drafting, the Court's "opinion has applicability only to this specific contract [or one just like it] and to no other."¹⁰⁴ Brokerage firms and courts now know that a broad arbitration clause together with a New York choice-of-law clause do not operate to prevent an arbitrator from awarding punitive damages, but other fundamental issues remain unresolved.

First, it is unclear whether a brokerage firm could eliminate punitive damages as a potential remedy by merely stating such an intention more precisely than Shearson.¹⁰⁵ The fact that the Court stressed the ambiguity of the agreement, but did not address Shearson's intent to deny the *Mastrobuonos* the opportunity to collect punitive damages in the arbitration proceeding, suggests that manifesting an intention to deny punitive damages could be permissible. However, in a footnote, the Court quoted NASD Rules of Fair Practice section 21(f)(4),¹⁰⁶ which states that no agreement may contain a condition that "limits the ability of the arbitrators to make any award."¹⁰⁷ The Court did not apply section 21(f)(4) to *Mastrobuono*, however, because it only affects agreements executed after September 7, 1989.¹⁰⁸ The effect of section 21(f)(4) on an agreement that attempts to disallow punitive damage awards by virtue of a New York choice-of-law clause, combined with clarifying

the reasonable meanings of a[n] . . . agreement . . . , that meaning is generally preferred which operates against the party who supplies the words." RESTATEMENT (SECOND) OF CONTRACTS § 206 (1979). The comment to that section explains that the rule is most often invoked where the agreement is a standard form contract (such as a customer agreement) and where the "drafting party has the stronger bargaining position" (as Shearson did in this case). *Id.* § 206 cmt. a.

¹⁰⁴ *Mastrobuono*, 115 S. Ct. at 1223 (Thomas, J., dissenting).

¹⁰⁵ See *id.* at 1217. The Court explained that the choice-of-law clause would have been deemed to speak to the authority of the arbitrators to award punitive damages if the agreement had said, "New York law" means "New York decisional law, including that State's allocation of power between courts and arbitrators, notwithstanding otherwise-applicable federal law." *Id.*

¹⁰⁶ See *id.* at 1218 n.6

¹⁰⁷ National Ass'n of Sec. Dealers, Inc., *Rules of Fair Practice* § 21(f)(4), in NASD Sec. Dealers Manual (CCH) ¶ 2171 (1994).

¹⁰⁸ See *Mastrobuono*, 115 S. Ct. at 1218 n.6. The agreement between Shearson and the *Mastrobuonos* was executed in October 1985. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, 715 (7th Cir. 1993) (noting this date), *rev'd*, 115 S. Ct. 1212 (1995).

language, is unclear.¹⁰⁹

Second, the *Mastrobuono* opinion lacks discussion about the usefulness of punitive damages as a tool to help the regulatory agencies police the conduct of the brokerage firms.

Third, the *Mastrobuono* Court ignored the arguments made by the Court of Appeals of New York in *Garrity* that arbitrators should not be permitted to award punitive damages as a matter of public policy.¹¹⁰

Fourth, the Court did not address whether, by eliminating punitive damages as an available remedy, a customer agreement becomes unfair to the customer or, moreover, an illegal adhesion contract.¹¹¹

Fifth, it remains unclear after *Mastrobuono* whether the procedures for awarding punitive damages in securities arbitration meet the requirements of due process as recently outlined by the Supreme Court.¹¹²

Because the *Mastrobuono* Court did not decisively determine the future role of punitive damages in securities arbitration, that task is left to the SROs in the securities industry.¹¹³ Determining the proper course of action will require the SROs to examine whether punitive damages in arbitration serve useful purposes in the securities industry and what constitutional limitations exist on their use. After studying the arguments, the SROs should conclude that the beneficial effects of punitive damages on the regulation of brokerage firms' conduct, and on investors' perception of the fairness of securities arbitration, outweigh the policy arguments against permitting them.

¹⁰⁹ For further discussion of § 21(f)(4), see *infra* part III.A.1.

¹¹⁰ For a discussion of *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976), see *infra* part III.C.

¹¹¹ See Richard A. Booth, *Punitive Damages and Securities Arbitration in the Wake of Mastrobuono*, 9 INSIGHTS 20 (1995) (noting that the Court in *Mastrobuono* left open the question whether it is reasonable for brokerage firms to remove punitive damages as an available remedy in arbitration).

¹¹² For a discussion of the constitutional restraints on punitive damages in securities arbitration, see *infra* part III.D.

¹¹³ For a discussion of SROs, see *supra* note 23.

III. THE SECURITIES INDUSTRY REGULATORS SHOULD MANDATE THAT PUNITIVE DAMAGES BE AWARDABLE IN SECURITIES ARBITRATION

A. *Punitive Damages Help Regulate the Brokerage Firms*

1. Section 21(f)(4): Bark, But No Bite

The NASD, the SRO primarily responsible for regulating securities firms, has already taken one step, albeit a tentative one, toward preventing firms from excluding punitive damages as a remedy in arbitration. In 1990, the NASD promulgated section 21(f)(4) of the Rules of Fair Practice which states that "[n]o agreement shall include any condition which . . . limits the ability of the arbitrators to make any award."¹¹⁴ The NASD maintains that this rule operates to prohibit brokerage firms from directly stating in the customer agreement that "arbitrators cannot award punitive damages."¹¹⁵ Moreover, firms may not attempt to indirectly limit the awards available to customers: "Where the governing law clause is used to limit an award, it violates Section 21(f)"¹¹⁶ In other words, section 21(f)(4) attempts to ensure that "if punitive damages . . . would be available under applicable law [in a judicial forum], then the agreement cannot limit . . . arbitrators' rights to award them."¹¹⁷

The rule does not, however, guarantee that punitive damages will be an available remedy in all securities arbitration cases. For example, customer agreements governed by the laws of a state such as Massachusetts, where punitive damages are not generally available in any forum, would neither offer investors punitive relief nor contravene section 21(f)(4).¹¹⁸ As a result, the remedies available

¹¹⁴ National Ass'n of Sec. Dealers, Inc., *Rules of Fair Practice* § 21(f)(4), in NASD Sec. Dealers Manual (CCH) ¶ 2171 (1994).

¹¹⁵ Masucci Interview, *supra* note 18.

¹¹⁶ *Predispute Arbitration Clauses in Customer Agreements*, NASD NOTICE TO MEMBERS 95-16 (National Ass'n of Sec. Dealers, Inc.), Mar. 1995, at 101, 102 [hereinafter NASD 95-16].

¹¹⁷ *Id.* (quoting Exchange Act Release No. 26,805, Fed. Sec. L. Rep. (CCH) ¶ 84,414 (May 10, 1989)).

¹¹⁸ See Telephone Interview with Deborah Masucci, Vice-President and Director of Arbitration, National Association of Securities Dealers (Sept. 19, 1995) [hereinafter Masucci Telephone Interview]; see also G. Richard Shell, *The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys' Fees*, 72 MASS. L. REV. 26, 28 (1987) (arguing that arbitrators ought to have the authority to award punitive damages in Massachusetts).

to investors may still vary depending on the choice-of-law clause contained in the agreement. It should be noted, however, that a brokerage firm must have some legitimate purpose for choosing, say, Massachusetts law to govern its customer agreements (because, for example, the firm is located there) and cannot simply do so in order to take advantage of that jurisdiction's ban on punitive damages.¹¹⁹ Nevertheless, "a national securities market [cannot] be well served by fragmenting relief based upon geographical location [of the brokerage firm]."¹²⁰

Furthermore, despite the Supreme Court's ruling in *Mastrobuono*, it is still possible for a firm to avoid punitive liability even when New York law governs the agreement. For instance, in June 1995, the Supreme Court of New York, in *Dean Witter Reynolds, Inc. v. Trimble*,¹²¹ declared that "an arbitration held in New York must be subject to the State's prohibition on punitive damages."¹²² This case differs from typical broker-customer cases because no written arbitration agreement existed between the parties. Instead, the Trimbles, the investors, were able to file for arbitration pursuant to the American Stock Exchange Constitution which mandates that its members agree to arbitrate disputes with investors in New York City.¹²³ The court reasoned that because the Trimbles elected to arbitrate their dispute with Dean Witter in New York, they were bound by the *Garrity* rule. Significantly, the court stated that if the case "involved a standard-form contract [such as a typical customer agreement] with the identical New York choice of law clause [as in *Mastrobuono*], this court would not be bound to interpret it in the same way as the U.S. Supreme Court did in *Mastrobuono*, since the interpretation of contracts is a matter of state law."¹²⁴ This statement suggests that courts may continue to interpret the effect of a New York choice-of-law clause differently, thereby increasing the importance of the SROs' taking a decisive position on the role of punitive damages in securities arbitration.

In sum, section 21(f)(4) alone does not function to prevent firms from excluding punitive damage awards from customer agreements.

¹¹⁹ See Masucci Telephone Interview, *supra* note 118.

¹²⁰ Katsoris, *supra* note 55, at 591.

¹²¹ 1995 WL 535611, at *3 (N.Y. Sup. Ct. June 13, 1995) (holding that the arbitration panel hearing the parties' dispute may not award punitive damages).

¹²² *Id.* at *3.

¹²³ See *id.* at *1 (describing how the case came before the court).

¹²⁴ *Id.* at *3 n.4 (citing *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1217 n.4 (1995)).

Therefore, if the regulatory agencies want to assure that punitive damages are an available remedy in arbitration, they must take more proactive measures. In order to evaluate whether they should insist on the availability of punitive damages in all securities arbitration cases, the SROs should first consider the purposes of punitive damages and assess whether those purposes will be served by permitting arbitrators to award them.

2. Punitive Damages As a Punishment and Deterrent

Punitive damages are primarily designed to punish the wrongdoer and to deter similar conduct in the future.¹²⁵ Therefore, to be effective a punitive damage award must be large enough to have a significant financial impact on the wrongdoer and must be sufficiently publicized so that others are aware of the offending conduct. One commentator made the case for punitive damages as a necessary deterrent in the securities industry arguing that "if the securities industry is insulated from the dangers of punitive damages . . . there will be far less deterrence and, consequently, a greater number of abuses."¹²⁶ The Fifth Circuit stressed that, without the possibility of substantial punitive liability, churning investors' accounts would become "low risk larceny" for a brokerage firm because it would only have to repay what it stole, assuming it gets caught at all.¹²⁷

In order to punish a brokerage firm and deter it from engaging in particular conduct in the future, the arbitrators' award must be large enough to make the firm take notice. Because some firms are wealthier than others, a set penalty will have disparate effects on individual firms. Therefore, the arbitrator must have the power to assess the net worth of the defendant firm in order to customize a penalty so that it provides adequate "bite."¹²⁸ Allowing arbitrators

¹²⁵ See 1 LINDA L. SCHLUETER & KENNETH R. REDDEN, PUNITIVE DAMAGES 24 (2d ed. 1989); see also Shell, *supra* note 118, at 29 (noting that punitive damages function to "(1) compensate plaintiffs for legal costs and fees, (2) compensate plaintiffs for injured feelings . . . , (3) deter and punish defendants . . . , and (4) deter other potential wrongdoers" (quoting David A. Rice, *Exemplary Damages in Private Consumer Actions*, 55 IOWA L. REV. 307, 309 (1969))).

¹²⁶ Brief Amicus Curiae in Support of Petitioners by the Public Investors Arbitration Bar Association at 13-14, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995) (No. 94-18) [hereinafter PIABA Brief].

¹²⁷ *Id.* at 14 (quoting *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 332 (5th Cir. 1981) (quoting STUART C. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES § 6.5 (1978))).

¹²⁸ See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 2,

to accept evidence of a firm's net worth and then to determine an appropriate penalty, guided by that information, is reasonable. Many brokerage firms are publicly held, making the job of discovering their net worth a simple matter of perusing their financial statements. Privately held firms could be required to present their tax returns or other financial data from which the arbitrators—or someone easily consulted by them—could determine their worth.¹²⁹

Publicizing a punitive award is crucial to its function as a general deterrent. There is a significant intangible cost to a firm when the public is informed that the firm has been subjected to punitive sanctions: namely, damage to its reputation.¹³⁰ The importance of maintaining a good reputation in a very competitive service industry—such as the brokerage business—provides another incentive for firms to avoid conduct that could result in punitive liability. Furthermore, if other firms are aware that certain conduct by one of their peers was severely punished, they will be motivated to avoid similar conduct. Therefore, the fact that the punitive award was assessed and, more importantly, the conduct prompting it should be publicized. Currently, arbitration awards and the parties against whom they are levied are made public,¹³¹ and, in fact, a private publisher reports the awards in a commercially available service.¹³² However, because full records of the arbitration proceedings are not

at 15 (W. Page Keeton ed., 5th ed. 1984) (stating that most courts allow evidence of defendant's wealth in order to determine an amount that will adequately punish the defendant). *But cf.* *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 19-22 (1991) (approving Alabama's policy of not allowing jurors to consider a defendant's wealth in making punitive damage awards but compelling the reviewing court to consider the defendant's "financial position" when assessing the fairness of an award).

¹²⁹ The arbitrators themselves may not be capable of determining a firm's net worth by reading its tax return. However, it seems that a reasonably accurate calculation could be made fairly simply. In cases where punitive damage penalties are going to be awarded, the arbitrators could choose an accountant to assess the defendant's net worth. Because the calculation need not be precise and is calculable from accessible and manageable documents such as tax returns, this process may not significantly increase the cost or time needed to dispose of the case. Estimates of the effect of this procedure on cost and time are, however, important factors to consider when judging its merit.

¹³⁰ See *Report of the Subcommittee on Punitive Damages of the NASD Legal Advisory Board*, in *NASD NOTICE TO MEMBERS* 94-54 (National Ass'n of Sec. Dealers, Inc.), July 1994, at 322, 329 [hereinafter *NASD Report*] (arguing that a firm's reputation, which is essential to new business, is damaged by cases brought against the firm).

¹³¹ See Shartel, *supra* note 23, at 31 (noting that since 1989 "arbitration awards have become part of the public record"); *Punitive Award Survey*, *supra* note 36, at 1, 3 (same).

¹³² *The Securities Arbitration Commentator*, a newsletter focusing on issues relating to securities arbitration, reports arbitration results regularly.

publicly available, the conduct that prompted the award is not always revealed.¹³³ More information about the offending conduct would be available if arbitrators were required to write an opinion or give reasons when awarding punitive damages; this would enhance the deterrent effect of the award.¹³⁴

Many channels exist to disseminate information about punitive damage awards to the public and the rest of the industry. First, many cases, especially those involving large firms, are reported in popular newspapers.¹³⁵ Second, smaller trade publications consistently report arbitration results.¹³⁶ Third, people learn about arbitral punitive damage awards through judicial proceedings, when courts vacate or confirm a challenged award.¹³⁷ Fourth, because the securities industry is a relatively small, closely intertwined community geographically concentrated primarily in New York City, information rapidly travels through the industry by word-of-mouth.¹³⁸ The existence of these mechanisms to spread information about punitive damage awards increases their deterrent effect. For example, the news of a large punitive damage award assessed to a firm for failure to properly supervise its account executives would likely be known quickly throughout the investment community. Such a story would certainly catch the attention of firm managers who would, in turn, likely check their own departments to make sure they were not committing similar violations.

Although it is clear in theory that punitive damages can help deter wrongdoing, the NASD maintains that sufficient deterrent mechanisms in the industry already exist, making punitive damages unnecessary for that purpose.¹³⁹ In a Notice to Members in July

¹³³ See National Ass'n of Sec. Dealers, Inc., *Code of Arbitration Procedure* § 41(f), in NASD Sec. Dealers Manual (CCH) ¶ 3741 (1993) (requiring that only the award be made publicly available).

¹³⁴ See *infra* part IV.B (recommending that arbitrators provide written reasons for the punitive damage awards they assess).

¹³⁵ See, e.g., *Prudential Securities Investor Is Awarded \$800,000 in Arbitration*, WALL ST. J., Dec. 24, 1992, at A2; *Raymond James & Assoc.: Firm Told to Pay \$378,000 for Handling of Account*, WALL ST. J., Aug. 22, 1991, at A4; Michael Siconolfi, *Appeals Court Says Merrill Must Pay Punitive Damages*, WALL ST. J., June 18, 1990, at C13 [hereinafter Siconolfi, *Appeals*]; Michael Siconolfi, *Arbitrators Rule Prudential Brokers Churned Account*, WALL ST. J., Mar. 4, 1992, at C1; Michael Siconolfi, *NASD Panel Imposes Punitive Damages Against Shearson for Actions of Broker*, WALL ST. J., Nov. 27, 1992, at C11.

¹³⁶ See *supra* note 132 and accompanying text.

¹³⁷ See Shell, *supra* note 118, at 34.

¹³⁸ See *id.*; Masucci Interview, *supra* note 18.

¹³⁹ See NASD *Solicits Public Comment on Approaches Governing Award of Punitive*

1994, the NASD discussed three aspects of the current policing system in the securities industry that operate to adequately deter wrongdoing. First, the NASD employs committees that continually oversee ordinary firm activity and investigate reports of firm misconduct.¹⁴⁰ Second, the NASD and the SEC have the authority to impose various sanctions on the firms and individual brokers which are designed to punish and deter inappropriate conduct.¹⁴¹ The NASD in particular can impose fines, suspend brokers or firms from conducting business, expel wrongdoers from the industry, and force firms to pay restitution.¹⁴² The Securities Industry Association (SIA), an organization representing the interests of the brokerage firms, argues that the NASD's authority to fine firms, as well as suspend them from certain trading activities, is by itself an effective deterrent.¹⁴³ According to the SIA, an additional penalty in the form of punitive damages serves as an unfair and unnecessary double punishment.¹⁴⁴ The third important aspect of the regulatory system, according to the NASD, is the "many avenues [that] trigger the NASD disciplinary process."¹⁴⁵ Because the enforcement mechanism of the NASD is easily invoked, "[t]here simply is no realistic danger that a claim of wrongdoing lodged against an NASD member would escape the attention of [the] disciplinary committees."¹⁴⁶

Although it is difficult to determine how to weigh the NASD and SIA arguments about the need for punitive damages, the use of private remedies to promote compliance with the law reflects a long tradition in the law, including securities law.¹⁴⁷

Damages in Arbitration, NASD NOTICE TO MEMBERS 94-54 (National Ass'n of Sec. Dealers, Inc.), July 1994, at 319, 319 [hereinafter NASD 94-54]; NASD *Report*, *supra* note 130, at 328-29.

¹⁴⁰ See NASD *Report*, *supra* note 130, at 328 (describing the duties of the District Business Conduct Committees and the Market Surveillance Committee in overseeing the conduct of member firms).

¹⁴¹ See *id.* (listing fines, censure, suspension, bans, expulsion, and restitution as possible sanctions available to the NASD, and listing actions for civil penalties, cease and desist orders, disgorgement of ill-gotten gains, and seek orders as possible sanctions available to the SEC).

¹⁴² See *id.*

¹⁴³ See Brief Amicus Curiae in Support of Respondent by the Securities Industry Association at 17-21, *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995) (No. 94-18) [hereinafter SIA Brief].

¹⁴⁴ See *id.*

¹⁴⁵ NASD *Report*, *supra* note 130, at 328.

¹⁴⁶ SIA brief, *supra* note 143, at 18. See *infra* notes 163-66 and accompanying text for a fuller description of how the NASD disciplinary process is triggered.

¹⁴⁷ See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (stating that "[p]rivate

3. Punitive Damages Provide an Incentive for Investors to Bring Claims

A second vital function of punitive damage awards is the incentive to file for arbitration that they provide to investors with small compensatory claims.¹⁴⁸ In theory, investors who otherwise would not have filed complaints because of the expense of arbitration and the small size of their claims will bring those claims in hopes of receiving a punitive damage award.¹⁴⁹ Encouraging all investors whose money has been mishandled to file complaints is important because the regulatory agencies in the securities industry depend, in part, on customer complaints to help trigger investigations of the brokerage firms.

Punitive damages will provide an incentive for investors to file claims if the ratio of punitive to compensatory awards is high and if punitive awards are made with regularity.¹⁵⁰ The statistics do not clearly indicate whether punitive damages provide this incentive to investors with small claims. From May 1989 through June 1992, punitive damages were awarded in just over two percent of the cases arbitrated.¹⁵¹ Furthermore, the ratio of the size of the punitive

enforcement of the proxy rules provides a necessary supplement to [SEC] action").

¹⁴⁸ See 1 SCHLUETER & REDDEN, *supra* note 125, at 30-31 (stating that a person who has suffered minimal damage and would normally not bring a claim may bring one if punitive damages are available).

¹⁴⁹ See KEETON ET AL., *supra* note 128, at 12.

¹⁵⁰ There is some disagreement among the courts as to whether compensatory damages are a necessary prerequisite for punitive awards. The majority of courts hold that punitive damages can only be awarded in cases in which actual damages have been awarded. See *id.* at 14. Compare *Sufas v. Cleveland Wrecking Co.*, 218 F. Supp. 289, 290 (E.D. Pa. 1963) (noting that under Pennsylvania law punitive damages cannot be awarded unless actual damages are also awarded) and *Kroger Grocery & Baking Co. v. Reeves*, 194 S.W.2d 876, 877 (Ark. 1946) (stating that the rule in Arkansas "as well as the general rule" is that punitive damages may not be awarded unless actual damages are assessed) with *Scalise v. National Util. Serv., Inc.*, 120 F.2d 938, 941 (5th Cir. 1941) (stating that "in the federal courts, the giving of punitive damages is not dependent upon . . . the allowance of actual damages") and *Wardman-Justice Motors, Inc. v. Petrie*, 39 F.2d 512, 516 (D.C. Cir. 1930) (holding that punitive damages are "in no wise dependent upon . . . the actual pecuniary loss of the plaintiff"). Keeton argues that if one purpose of punitive damages is to give people with little measurable loss an incentive to file their complaints, there should be no compensatory damage requirement. See KEETON ET AL., *supra* note 128, at 14. For example, in a defamation case, the defamed may have only suffered embarrassment and ridicule and thus be ineligible for compensatory damages; yet in order to encourage such a person to bring suit, and deter the defamer and others, punitive damages should be awarded.

¹⁵¹ See *Punitive Award Survey*, *supra* note 36, at 7 (reporting that between May 1989 and June 1992 punitive damages were awarded in only 147 out of 6870 cases).

award to the compensatory award was 0.7:1 through the last half of 1991.¹⁵² Of the 172 punitive damages awards that were measured, 102 were for \$50,000 or less.¹⁵³

Although these statistics suggest punitive damages do not encourage investors to pursue small claims, other factors indicate that they do. First, in the first half of 1992, the ratio of punitive to compensatory damages rose to 1.3:1.¹⁵⁴ Second, the Supreme Court has indicated that there is room for the ratio to increase to 4:1 before coming "close to the line" of impropriety.¹⁵⁵ Even this limit may be flexible, since the Court recently upheld a punitive damage award 526 times greater than the compensatory damages.¹⁵⁶ At least one commentator believes that the decision in that case sent a message that the Supreme Court will not attempt to define a ratio or dollar limit on the permissible size of punitive damage awards.¹⁵⁷ Third, punitive damages are often awarded in cases with compensatory awards of \$50,000 or less.¹⁵⁸ Thus, although punitive awards for investors with small claims may not be large in absolute terms, they do offer this group of complainants an opportunity to increase the size of their awards. Fourth, although difficult to measure, it is logical to believe that the prospect of punitive damages causes brokerage firms to settle cases that they would have otherwise arbitrated.¹⁵⁹ Settlement helps investors by relieving them of the cost of arbitration and by guaranteeing them an award. Furthermore, the settlement amount may be larger than the firm would have otherwise paid had the fear of a punitive award not entered their settlement calculation.¹⁶⁰

¹⁵² See NASD Report, *supra* note 130, at 322.

¹⁵³ See *Punitive Award Survey*, *supra* note 36, at 5.

¹⁵⁴ See NASD Report, *supra* note 130, at 322.

¹⁵⁵ See *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 23 (1991) (noting that a punitive damage award four times as great as the compensatory award was "close to the [permissible] line"); see also *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 332 (1981) (stating that a ratio of 3:1 is a proper "rule of thumb" in a churning case).

¹⁵⁶ See *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711, 2718-23 (1993) (upholding a \$10 million punitive damage award that accompanied a \$19,000 compensatory award).

¹⁵⁷ See Memorandum by Haythe & Curley (Aug. 1994) (on file with author) (discussing the implications of recent court decisions on punitive damage awards in litigation).

¹⁵⁸ See *Punitive Award Survey*, *supra* note 36, at 5 (providing a chart that demonstrates that nearly half of the 172 punitive awards surveyed were made to investors with compensatory awards of less than \$50,000).

¹⁵⁹ See PIABA Brief, *supra* note 126, at 13 (noting that the prospect of a punitive damage award may prompt the wrongdoer to settle the dispute).

¹⁶⁰ See Masucci Interview, *supra* note 18 (speculating that the desire to avoid a

The importance of punitive damages as an incentive to investors to bring small claims extends beyond merely helping investors receive monetary relief. In the process of filing for arbitration, investors assist the regulatory agencies in their effort to effectively police the brokerage firms. Despite the contention by the NASD and the SIA that punitive damages are not necessary as a deterrent, they could indirectly aid the regulatory agencies' policing efforts by increasing the number of complaints filed, thereby sparking more investigations. Gathering as many complaints of broker misconduct as possible is particularly important in the securities industry where one complaint could very easily help reveal a larger pattern of misconduct by a particular broker or department within a firm. For example, if a broker is caught churning one account he oversees, it is likely that he is also churning other accounts. If his behavior is due in part to insufficient supervision by the firm's management, it is quite possible that other brokers in his department are churning accounts too. In this scenario, a customer's complaint, regardless of the size of the claim, can be very valuable. The investor's complaint may trigger an NASD investigation that uncovers widespread churning at the firm or by a particular broker.¹⁶¹ "Clearly, the SEC [and the NASD] cannot scrutinize all securities transactions and practices, nor can [they] prosecute every complaint. When transgressors escape liability because investors do not sue, broker fraud in the particular case is rewarded, and similarly inclined brokers are left undeterred."¹⁶²

The securities arbitration system works particularly well to ensure that if a request for arbitration is filed, the NASD knows about it. Normally, an investor will file a complaint with the NASD along with a request for arbitration.¹⁶³ The complaint goes

punitive damage sanction may make brokerage firms more willing to settle disputes on terms more favorable to investors).

¹⁶¹ Cf. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1379-80 (11th Cir. 1988). In *Bonar*, the plaintiffs did not know that their broker had embezzled money from their account until Dean Witter, the brokerage firm, told them several months after they closed their account. Dean Witter discovered that one of its former brokers had stolen money from several accounts after it received an inquiry from a former customer of that broker concerning her account. This investor's inquiry prompted Dean Witter to audit all the accounts managed by that broker. It was during this audit that Dean Witter discovered that the broker had stolen money from the Bonars. Although the other customer's complaint led the firm, not the NASD, to conduct an investigation, it is apparent that every complaint, regardless of the dollar amount it involves, can potentially uncover serious broker misconduct.

¹⁶² Wilson, *supra* note 4, at 153.

¹⁶³ See Masucci Interview, *supra* note 18 (explaining how the arbitration procedure

immediately to the regulatory division of the NASD.¹⁶⁴ In addition, notices of all awards granted pursuant to arbitration go to the regulatory division.¹⁶⁵ Depending on the nature of the complaint filed, or if the arbitrators award significant damages, punitive or compensatory, the NASD will look into the matter itself. Thus, an arbitral award of punitive damages signals the NASD that a particular case is probably worthy of further investigation. The investigation can then lead to additional sanctions.¹⁶⁶

B. Precluding Punitive Damages May Render Customer Agreements Unfair and Possibly Illegal

1. "Stacking the Deck" Against Customers

An additional reason for allowing punitive damages is to make securities arbitration equitable by providing investors access to the same remedies in arbitration that would be available to them in court. It is recognized that "the purpose of arbitration is to provide a substitute for the expense and delay of court litigation . . . without compromising fairness."¹⁶⁷

As mandatory arbitration clauses have become increasingly popular in customer agreements, investors have begun to complain that the terms of these agreements are unfair because they heavily favor the brokerage firms.¹⁶⁸ Investors accuse firms of "stacking the deck" against them by dictating the significant terms of dispute resolution. In particular, firms force disputes to be settled in arbitration rather than in litigation, and they limit the investors' choices as to the particular arbitration forum in which the complaint can be heard. Specifically, many firms only permit arbitration before SRO forums such as the NASD or NYSE, and not before independent forums like the AAA.¹⁶⁹ Forcing investors to bring their complaints to forums that are in the "brokerage firm's proverbial backyard" invites skepticism about the opportunity for customers to receive unbiased treatment.¹⁷⁰ The perception that

operates to inform the NASD of possible firm misconduct).

¹⁶⁴ See *id.*

¹⁶⁵ See *id.*

¹⁶⁶ See *supra* notes 141-42 and accompanying text (listing sanctions available to the NASD and the SEC).

¹⁶⁷ Katsoris, *supra* note 55, at 591.

¹⁶⁸ See PIABA Brief, *supra* note 126, at 29.

¹⁶⁹ See GAO, *supra* note 23, at 4.

¹⁷⁰ See PIABA Brief, *supra* note 126, at 25-26.

the deck is stacked against investors will be further exacerbated if firms are able effectively to eliminate punitive damages from arbitration.¹⁷¹

2. Contracts of Adhesion

It has also been suggested that, without the availability of punitive damages, customer agreements might be regarded as illegal adhesion contracts.¹⁷² Brokerage firms currently have a decided advantage in dictating the terms of their customer agreements. An examination of the requirements of an adhesion contract suggests that if punitive damages are eliminated as a potential remedy, these agreements might become unenforceable contracts of adhesion.

An agreement can be deemed an adhesion contract if it is a "[s]tandardized contract form offered to consumers . . . on [an] essentially 'take it or leave it' basis without affording [the] consumer [a] realistic opportunity to bargain and under such conditions that [the] consumer cannot obtain [the] desired product or services [elsewhere]."¹⁷³ Such an agreement, even if based on true mutual assent, may be unenforceable if it is unconscionable or against public policy.¹⁷⁴

In order to judge whether standard customer agreements meet the test for an illegal adhesion contract, it is helpful first to isolate the separate elements of the definition of "adhesion contract" and evaluate the terms of the customer agreements in that context. First, to be considered an adhesion contract, the customer agreement must be offered on a "take it or leave it" basis—which is what almost invariably happens in the brokerage business. For virtually all customers, bargaining with respect to the terms of the customer agreement is not possible.¹⁷⁵

Second, adhesion contracts can arise when market conditions prevent customers from procuring similar products or services from another source without having to sign an agreement that includes

¹⁷¹ See Katsoris, *supra* note 55, at 593-94.

¹⁷² See PIABA Brief, *supra* note 126, at 21.

¹⁷³ BLACK'S LAW DICTIONARY 40 (6th ed. 1990).

¹⁷⁴ See JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 418 (3d ed. 1987); cf. *Lechmere Tire and Sales Co. v. Burwick*, 277 N.E.2d 503, 506 (Mass. 1972) (holding that a credit card agreement, although qualifying as an adhesion contract, was not "so unconscionable as to require that it not be enforced").

¹⁷⁵ See John F. Cooney et al., *Pre-Dispute Arbitration Agreements*, 63 *FORDHAM L. REV.* 1511, 1519 (1995) (observing that customers cannot negotiate the terms of arbitration agreements with brokerage firms).

an arbitration clause. In short, the question is whether sufficient competition exists in the brokerage industry to allow investor choice. Currently, investors are able to choose firms that do not require an arbitration agreement as a condition of doing business.¹⁷⁶ Moreover, some of those firms that do require arbitration nonetheless incorporate choice-of-law clauses from states other than New York.¹⁷⁷ It is quite possible, however, that firms will interpret the Supreme Court's opinion in *Mastrobuono* to uphold the viability of banning punitive damages altogether through the use of a New York choice-of-law clause and specific language defining its application.¹⁷⁸ If that is the case, and the regulatory agencies in the securities industry do not intervene, all firms might choose New York law to govern their agreements.¹⁷⁹

Furthermore, today's large firms, which handle seventy-five percent of all investor accounts, require arbitration agreements with New York choice-of-law clauses for margin and options accounts.¹⁸⁰ Adjusting the language in future agreements for these types of accounts in order to meet the Supreme Court's requirements of specificity as hinted in *Mastrobuono* would be simple. Although smaller firms also handle margin and options accounts, it is probable that the range and quality of services offered at these firms are not equivalent to those offered by the biggest firms. In that sense, there is no real choice for investors who require the services that only large firms can provide. The SEC, however, speculates that market forces will change this situation if the issue

¹⁷⁶ See GAO, *supra* note 23, at 29 (listing the requirements of small, medium, and large brokerage firms with respect to mandatory agreements to arbitrate).

¹⁷⁷ See, e.g., *Punitive Damages & Pre-Dispute Arbitration Agreements*, SEC. ARB. COMMENTATOR, Nov. 1994, at 10, 11 (1994) (providing excerpts of customer agreements, one of which uses a Florida choice-of-law clause).

¹⁷⁸ As noted in the discussion of *Mastrobuono*, see *supra* note 105, the Supreme Court cited language that the agreement could have contained if the parties intended New York decisional law to govern the authority of arbitrators to award remedies.

¹⁷⁹ The NASD's current interpretation of their Rules of Fair Practice § 21(f)(4) suggests that a New York choice-of-law clause cannot be used to prevent arbitrators from awarding punitive damages. See NASD 95-16, *supra* note 116, at 102. The NASD's position on this matter, however, has been criticized by member firms, suggesting that it could be modified in the future. See Masucci Telephone Interview, *supra* note 118 (stating that some NASD member firms are unhappy with the NASD's interpretation of § 21(f)(4)).

¹⁸⁰ See GAO, *supra* note 23, at 29 (detailing the percentage of business handled by firms according to their size). In a margin account, "the broker-dealer may extend credit of up to 50 percent of the purchase price to the investor to purchase securities." *Id.* at 16. In an options account, "the investor may purchase the right to buy or sell securities before a specific date." *Id.*

is important enough to investors.¹⁸¹ The argument runs that, as firms compete for business, they may find that offering agreements with arbitration provisions that permit punitive damages attracts more clients. The likelihood that firms would expose themselves to unpredictable and possibly very large punitive damage sanctions, merely to attract business, however, seems tenuous. As a marketing tool, potential punitive damage liability—and the increased legal fees expended to fight claimants—is very expensive.

If the customer agreements offered by the brokerage firms are nearly identical and not open for negotiation (that is, they are adhesion contracts), they may be deemed illegal and unenforceable adhesion contracts if they violate public policy or are unconscionable. Customer agreements that prevent investors from receiving punitive damages do not seem contrary to the public policy objectives expressed in the FAA.¹⁸² The FAA policy regarding arbitration is simply to enforce the parties' agreement according to its terms without dictating what these terms ought to be.¹⁸³

A close study of the aspects of an agreement most likely to be cited as unfair or unconscionable reveals that, barring a "no punitive damages" provision, arbitration agreements as they are currently drafted are not stacked in favor of the firms, and, therefore, should not be deemed unconscionable. Should firms construct the agreements to forbid punitive damages, however, investors will have a much more persuasive argument that they are unconscionable.

Critics of these mandatory arbitration agreements first claim that the initial step toward unconscionability occurs when firms force all disputes to be resolved in arbitration instead of litigation. Although firms do enjoy the benefits arbitration offers over litigation, investors profit as well. For example, investors with small claims gain considerably from arbitration because they can bring their complaints to arbitration without incurring the expense of hiring a lawyer.¹⁸⁴ Furthermore, if punitive damages are available,

¹⁸¹ See DANNY ERTEL & RALPH C. FERRARA, *BEYOND ARBITRATION: DESIGNING ALTERNATIVES TO SECURITIES LITIGATION* 39 (1991).

¹⁸² See Katsoris, *supra* note 55, at 595 (hypothesizing that an arbitration agreement that prohibits punitive damages would probably not be contrary to public policy according to the principles of the FAA).

¹⁸³ See *Volt Info. Sciences v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989) (stating that the FAA's "passage 'was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered'" (quoting *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219-20 (1985))).

¹⁸⁴ See *supra* part I.B (describing the benefits arbitration brings to investors and

investors are able to collect the same remedial damages in arbitration as in litigation without expending the financial resources and time that litigation demands.

Second, critics argue that firms which restrict arbitration to SRO forums gain an unfair advantage.¹⁸⁵ Intuitively, this accusation has merit. The SROs are funded by the brokerage firms.¹⁸⁶ In turn, it is the SROs, not the parties, who select the arbitrators.¹⁸⁷ The specter of pro-firm bias in an SRO forum, then, looms large. Nonetheless, a study performed by the General Accounting Office (GAO) comparing arbitration results in SRO forums with those in AAA forums indicates that "the forum in which a case [is] arbitrated [is] not a factor that affect[s] whether investors receive[] an award or the proportion of any award the investor receive[s]."¹⁸⁸ In addition to impartiality, the SRO forums hold another advantage for investors: their filing fees are considerably cheaper than those of AAA forums.¹⁸⁹

At the heart of investors' fear that SRO forums are unfair is a belief that the arbitrators themselves are biased in favor of the industry. This belief is based on the unwarranted assumption that all SRO arbitrators are loyal to the industry. In fact, on an SRO panel of three arbitrators, only one may be an "industry arbitrator," meaning that she has some involvement or affiliation with the securities industry.¹⁹⁰ The other two must be public arbitrators who have no connection to the industry.¹⁹¹

Studies and anecdotal evidence also contradict the contention

brokerage firms).

¹⁸⁵ Most firms do not include AAA forums among those which an investor can choose. For example, in margin and options accounts, approximately 25% of the large firms give investors the option to choose an AAA or SRO forum. Significantly less than 50% of all accounts in all firms offer the AAA as an optional forum. See GAO, *supra* note 23, at 32.

¹⁸⁶ See Masucci Interview, *supra* note 18.

¹⁸⁷ See Katsoris, *supra* note 20, at 1128.

¹⁸⁸ GAO, *supra* note 23, at 35.

¹⁸⁹ See *id.* at 46-47 (comparing filing costs in SRO and AAA arbitration forums). As mentioned previously, no data exists on the cost of litigating a broker-investor dispute because these disputes are either settled or disposed of in arbitration. See *id.*

¹⁹⁰ See National Ass'n of Sec. Dealers, Inc., *Code of Arbitration Procedure* § 19, in NASD Sec. Dealers Manual (CCH) ¶ 3719 (1993). An "industry arbitrator" includes anyone who worked in the securities industry or has been associated with a securities dealer in the past three years. In addition, attorneys, accountants, and other professionals who devote more than 20% of their time to securities industry clients are considered industry arbitrators. See *id.*

¹⁹¹ See *id.*

that industry arbitrators favor the brokerage firms. The GAO stated that its "review found no evidence that arbitrators' decisions favored investors or the industry."¹⁹² Indeed, one insider believes that industry arbitrators are often tougher on the firms because they have a personal interest in the reputation of the industry and want to root out any corruption.¹⁹³

Not only are industry arbitrators unbiased, but their participation actually *benefits* the arbitration process because they are familiar with the issues. One judge noted that, "an arbitrator steeped in the practice of a given trade is often better equipped than a judge [or non-affiliated arbitrator] . . . to decide what behavior so transgresses the limits of acceptable commercial practice in that trade [that a punitive damage award is appropriate]"¹⁹⁴ Therefore, it may be particularly advantageous to the investor pressing a claim against a broker to have an industry arbitrator on the panel. An arbitrator with a superior knowledge of the issues will be able to resolve the case more quickly, thereby reducing the overall cost of arbitration, and will be better able to spot situations of egregious conduct, potentially improving the investor's chances of obtaining a punitive damage award.¹⁹⁵

Thus, the fact that firms require, as a precondition to doing business, that investors agree to submit their disputes to arbitration conducted in part by industry arbitrators in an SRO forum does not support the argument that customer agreements are unconscionable. These provisions benefit both sides to some degree, and none of them is unduly oppressive.

The third objection to mandatory arbitration agreements, and the strongest argument for concluding that they are unconscionable, is that they foreclose the opportunity to seek punitive damages. Some investors argue that "construing the . . . agreement to arbitrate [in such a way that] result[s] in a waiver of the [investors'] ability to recover punitive damages for [] egregious misconduct . . . renders the agreement unconscionable."¹⁹⁶ Calamari and Perillo state that unconscionability is suggested when one party deprives

¹⁹² GAO, *supra* note 23, at 58.

¹⁹³ See Masucci Interview, *supra* note 18.

¹⁹⁴ Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 365 (N.D. Ala. 1984) (upholding an arbitration panel's punitive damage award in a breach of contract dispute), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

¹⁹⁵ See *supra* note 32 and accompanying text (discussing the advantages of having knowledgeable arbitrators preside over the cases).

¹⁹⁶ Petitioner's Brief, *supra* note 1, at 63.

the other of his right to recover for the wrong done.¹⁹⁷ Whether investors truly have a "right" to punitive damages is not clear. But if the primary purpose of arbitration is to benefit both parties by saving the cost and time of litigation, it does not seem fair for one side, the brokerage firms, to also use arbitration as "a vehicle to strip [investors] of their remedies."¹⁹⁸ Nevertheless, establishing that a contract is unconscionable is difficult. Simply having a superior bargaining position, and taking advantage of it, does not render an agreement unconscionable. Even so, whether customer agreements that forbid punitive damages are illegal adhesion contracts or just highly unfair, industry regulators should mandate that punitive damages be available to investors under certain conditions.

C. *The Argument Against Punitive Damage Awards As
a Matter of Public Policy Is Not Persuasive
in the Context of Securities Arbitration*

The New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.*¹⁹⁹ declared that under New York law arbitrators are not permitted to award punitive damages as a matter of public policy.²⁰⁰ The dispute in *Garrity* involved an author, Ms. Garrity, who sued her publisher for failing to pay her agreed-upon royalties.²⁰¹ The issue was settled in arbitration pursuant to the contract, and Ms. Garrity was awarded \$7500 in punitive damages in addition to \$45,000 in compensatory damages.²⁰² The Court of Appeals vacated the punitive damage award, stating that "[a]n arbitrator has no power to award punitive damages, even if agreed upon by the parties."²⁰³ The court set forth several reasons for its decision which are discussed below. Close scrutiny of its rationale, however, reveals that the *Garrity* court's holding should not be applied in the securities arbitration context to prevent arbitrators from awarding punitive damages.

The *Garrity* court first argued that punitive damages are a "social

¹⁹⁷ See CALAMARI & PERILLO, *supra* note 174, at 424.

¹⁹⁸ Katsoris, *supra* note 55, at 591.

¹⁹⁹ 353 N.E.2d 793 (N.Y. 1976).

²⁰⁰ See *id.* at 795.

²⁰¹ See *id.* at 794.

²⁰² See *id.*

²⁰³ *Id.* (citations omitted).

exemplary 'remedy', not a private compensatory remedy"²⁰⁴ and should therefore only be awarded in cases where the "wrong complained of is morally culpable" and the punishment is designed to deter future wrongdoing.²⁰⁵ Punitive damages in securities cases typically meet this standard. As discussed previously, one of the primary functions of punitive damages in securities arbitration is to deter brokers from engaging in fraudulent, that is, morally culpable, conduct such as unauthorized trading and account churning.²⁰⁶

Second, the *Garrity* court stressed that penalties or punitive damages have traditionally not been enforced in breach of contract actions such as the one between Ms. Garrity and her publisher.²⁰⁷ This argument does not apply to typical investor-broker disputes because they do not arise from a breach of contract. Rather, the disputes tend to involve deceptive misconduct of some sort by the broker.²⁰⁸

Third, the court maintained that the "power to punish [is] a monopoly of the State" and cannot be delegated to private parties.²⁰⁹ The court feared that the weaker party in a private agreement would be subject to the "uncontrolled use of coercive economic sanctions" by a private referee, such as an arbitrator, if the party with superior bargaining position could insist that punitive damages be an available remedy in their dispute resolution agreement.²¹⁰ This paternalistic argument is only persuasive in cases in which the party that is at risk of a punitive sanction is unsophisticated and unable to protect itself. In the context of securities arbitration, this protection is unnecessary because the brokerage firms—the parties who would be subject to the punitive

²⁰⁴ *Id.* at 795 (quoting *Walker v. Sheldon*, 179 N.E.2d 497, 498 (1961)).

²⁰⁵ *Id.*

²⁰⁶ See *supra* notes 34-37 and accompanying text (describing the types of conduct that typically result in punitive damage awards in securities arbitration).

²⁰⁷ See *Garrity*, 353 N.E.2d at 795.

²⁰⁸ See, e.g., *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1379, 1379 (11th Cir. 1988) (vacating arbitration award that found brokerage account executive guilty of stealing money from investor's account but recognizing arbitrators' power to award punitive damages); *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826, 828 (Ct. App. 1993) (describing brokerage account manager who was engaged in "deceptive practices, account churning and unauthorized . . . stock trades"), *cert. denied*, 114 S. Ct. 2182 (1994); see also *Siconolfi, Appeals, supra* note 135, at C13 (reporting that a Merrill Lynch broker churned the account of a deceased widow in order to generate commissions).

²⁰⁹ *Garrity*, 353 N.E.2d at 797.

²¹⁰ *Id.* at 796.

sanctions in the overwhelming majority of cases²¹¹—are indisputably sophisticated and capable of protecting their interests. Moreover, they dictate the terms of customer agreements.²¹²

Fourth, the court emphasized the importance of “judicial supervision” of punitive damage awards.²¹³ The court worried that without it, arbitrators’ awards would amount to an “unlimited draft upon judicial power.”²¹⁴ This concern is shared by the United States Supreme Court.²¹⁵ Therefore, the regulatory agencies in the securities industry must address this issue as they implement changes to the current arbitration procedures. Part IV recommends, in part, that they address this issue by subjecting punitive damage awards to full judicial review.

In sum, the *Garrity* court’s reasons for not allowing arbitrators to award punitive damages do not withstand scrutiny in the securities arbitration context.

D. *Constitutional Restraints on Arbitrators’ Authority to Award Punitive Damages*

Determining that punitive damages should be available in securities arbitration as a matter of public policy is only the first step in ensuring that this remedy will be available to investors. Before they vest arbitrators with the power to award punitive damages, the regulatory agencies must address the issues raised in a group of Supreme Court cases that hold that the Due Process Clause of the Fourteenth Amendment requires certain safeguards, including judicial review, before a jury can award punitive damages.²¹⁶ Although the Court has not expressly applied this requirement to arbitral awards of punitive damages, it seems probable that it will for the reasons discussed below.²¹⁷

²¹¹ See *Punitive Award Survey*, *supra* note 36, at 4 (illustrating that of the 174 punitive damage awards made between May 1989 and June 1992, 91% (154) were assessed against brokerage firms, while only 2% (4) were levied against customers).

²¹² See Cooney et al., *supra* note 175, at 1519 (noting that brokerage firms do not typically negotiate the terms of customer agreements).

²¹³ *Garrity*, 353 N.E.2d at 796 (quoting *Matter of Publishers’ Ass’n v. Newspaper & Mail Deliverers’ Union*, 114 N.Y.S.2d 401, 404 (App. Div. 1952)).

²¹⁴ *Id.*

²¹⁵ See *infra* part III.D (discussing constitutional constraints on arbitrators’ authority to award punitive damages).

²¹⁶ See, e.g., *Honda Motor Co. v. Oberg*, 114 S. Ct. 2331, 2333 (1994) (declaring an amendment to the Oregon Constitution unconstitutional because it essentially eliminated the opportunity for judicial review of punitive damage awards).

²¹⁷ But see *Davis v. Prudential Sec., Inc.*, 59 F.3d 1186 (11th Cir. 1995). In *Davis*,

In order for the constitutional guarantees of due process to apply to securities arbitration, the requirement of state action must be met.²¹⁸ Punitive damage awards in securities arbitration cases involve state action for two reasons. First, the government compels brokerage firms to be members of an SRO.²¹⁹ If the government forces membership in an organization, the organization's procedures (in this case SRO arbitration procedures) may not violate the Constitution, just as procedures undertaken directly by the government cannot.²²⁰ In effect, private actors acting under state

the court refused to declare an arbitration panel's punitive damage award against Prudential a violation of the Due Process Clause of the Fifth and Fourteenth Amendments. *See id.* at 1190-94. The court held that there was no state action involved in the arbitration proceeding or in the lower court's enforcement of the arbitrators' award. *See id.* at 1191-92. The court explained that arbitration was the product of a voluntary contractual agreement between the parties and was conducted as a private proceeding. *See id.* at 1191.

This case is not dispositive in determining the existence of state action in the majority of securities arbitration cases, however, because the arbitration proceeding in *Davis* was conducted in an AAA forum, not an SRO forum (such as the NASD, NYSE, or AMEX). As stated below, *see infra* text accompanying note 219, brokerage firms are required by the government to be members of an SRO; therefore, the SROs' procedures, including their arbitration rules, should be subject to constitutional constraints. Because the vast majority of securities arbitration cases are heard in SRO forums, the debate about whether constitutional limitations apply in securities arbitration continues. The NASD itself takes a conservative position on the matter: it believes that arbitrations conducted in SRO forums are in fact subject to the requirements of due process. *See NASD Report, supra* note 130, at 327. As a result, the NASD may conclude, regardless of any court's position on the issue, that providing brokerage firms with protections consistent with the requirements of due process is a fair trade-off for mandating that punitive damages be available.

²¹⁸ The state action doctrine makes the constitutional requirement of due process applicable only to state actors or private parties who assume the role of the state by performing governmental functions. *See* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 12.1, at 457 (4th ed. 1991) (explaining the application of the state action doctrine). A private party may be considered a state actor and therefore held to constitutional standards if (1) there is a "sufficient nexus between the state and the private actor which compelled the private actor to act as it did," (2) the private actor is performing a "traditionally public function," or (3) there is a "symbiotic relationship" between the state and the private actor." *See Citizens to End Animal Suffering and Exploitation, Inc. v. Faneuil Hall Marketplace, Inc.*, 745 F. Supp. 65, 69 (D. Mass. 1990). The Supreme Court recently employed this three-factor analysis for determining the existence of state action. *See Edmonson v. Leesville Concrete Co.*, 500 U.S. 614, 621 (1991) (holding that the use of peremptory challenges in federal court by a private litigant qualified as state action).

²¹⁹ *See NASD Report, supra* note 130, at 327.

²²⁰ *See id.*; *see also Keller v. State Bar*, 496 U.S. 1, 12-16 (1990) (holding that the state bar association, in which membership is compelled by the state, must uphold its members' First and Fourteenth Amendment rights).

compulsion are considered state actors.²²¹ Second, imposing punitive damages is a "public function."²²² In theory, "if private persons engage in governmental functions . . . their activities are subject to the same Constitutional restrictions that are imposed on the state itself."²²³ The constitutional restrictions on punitive damage awards have been clarified by the Supreme Court in three recent decisions.

In *Pacific Mutual Life Insurance Co. v. Haslip*,²²⁴ the Court held that the Due Process Clause requires that courts employ procedural safeguards to ensure that the size of "a punitive damage award is reasonably related to the goals of deterrence and retribution."²²⁵ In upholding the jury's punitive damage award, the Court reasoned that the due process requirements were met because (1) the trial court gave the jury instructions on factors it should consider in making the award, (2) the trial judge stated his reasons for upholding the award in the record, and (3) the appellate court followed specific guidelines to determine whether the award was reasonable.²²⁶

In *TXO Production Corp. v. Alliance Resources Corp.*,²²⁷ the Court upheld a punitive damage award of ten million dollars—526 times larger than the compensatory damage award.²²⁸ In explaining its affirmance of the punitive amount, the Court stressed the importance of procedural safeguards. The fact that the "award was reviewed and upheld by the trial judge" and that it was a "product of . . . process" gave rise to "a strong presumption of validity."²²⁹ The availability of a procedure for appealing an award of punitive damages also weighed into the Court's decision.²³⁰

²²¹ See NASD Report, *supra* note 130, at 327.

²²² *Id.* Compare *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 796 (N.Y. 1976), in which the court stated that "[p]unitive sanctions are reserved to the State" and that "the use of coercion [ought to] be controlled by the state," thereby implying that the act of meting out punishment in the form of punitive damages is a state function. Therefore, if arbitrators punish with punitive damages, they are performing a state function.

²²³ NASD Report, *supra* note 130, at 327.

²²⁴ 499 U.S. 1 (1991).

²²⁵ *Id.* at 21.

²²⁶ See *id.* at 23.

²²⁷ 113 S. Ct. 2711 (1993).

²²⁸ See *id.* at 2721, 2724.

²²⁹ *Id.* at 2720.

²³⁰ See NASD Report, *supra* note 130, at 326 ("In addition, all of the Justices seemed to believe that a process that includes the availability of some sort of appeal of a punitive damages award is constitutionally necessary.").

In *Honda Motor Co. v. Oberg*²³¹ the Court reiterated the need for meaningful judicial review of punitive damage awards. *Honda* concerned an amendment to the Oregon Constitution that prohibited judicial review of a jury's punitive damage award "unless the court [could] affirmatively say there [was] no evidence to support the verdict."²³² This rule made judicial review of punitive damage awards virtually impossible, a result the Supreme Court held to be unacceptable. The Court noted that "[j]udicial review of the size of punitive damage awards has been a safeguard against excessive verdicts for as long as punitive damages have been awarded."²³³ Oregon had effectively eliminated the safeguard of judicial review and provided no substitute to protect defendants. Consequently, the Supreme Court declared the amendment unconstitutional, stating that "Oregon's denial of judicial review of the size of punitive damage awards violates the Due Process Clause of the Fourteenth Amendment."²³⁴

The Supreme Court's decisions in *Haslip*, *TXO*, and *Honda* make it clear that the Due Process Clause requires that punitive damage awards be subject to certain procedural protections. The current procedures in securities arbitration do not meet the requirements set by the Court. As one judge from the Eighth Circuit stated:

In the arbitration setting we have almost none of the protections that fundamental fairness and due process require for the imposition of [punitive damages] Discovery is abbreviated if available at all. The rules of evidence are employed, if at all, in a very relaxed manner. The factfinders (here the panel) operate with almost none of the controls and safeguards assumed in *Haslip*.²³⁵

In addition, the scope of judicial review in securities arbitration is very limited. As discussed above,²³⁶ under § 10(a)(4) of the FAA, arbitrators' awards can be vacated only where the "arbitrators [have] exceeded their powers."²³⁷ Although the limited procedural protections and the narrow scope of judicial review help preserve the benefits of arbitration such as speed, simplicity, reduced

²³¹ 114 S. Ct. 2331 (1994).

²³² *Id.* at 2334.

²³³ *Id.* at 2335.

²³⁴ *Id.* at 2341.

²³⁵ *Lee v. Chica*, 983 F.2d 883, 889 (8th Cir.) (Beam, J., dissenting in part), *cert. denied*, 114 S. Ct. 287 (1993).

²³⁶ See *supra* note 83 and accompanying text.

²³⁷ Federal Arbitration Act, 9 U.S.C. § 10(a)(4) (1994).

expense and finality, the requirements of due process must also be met.²³⁸

IV. A PROPOSAL FOR CHANGING THE CURRENT ARBITRATION PROCEDURE

The current procedures for issuing and appealing punitive damage awards in securities arbitration are in need of reform. In particular, the arbitration system must adjust to accommodate the due process requirements of the Fourteenth Amendment. This Part briefly evaluates some popular suggestions for reform and ultimately recommends that arbitrators follow established guidelines when making punitive awards and that the awards be separately reviewable by a court.

A. Popular Suggestions That Miss the Mark

Several recent proposals have recommended various adjustments to the rules regarding punitive damage awards in securities arbitration. None of these recommendations represents a true improvement to the current system.

First, one proposal recommended that a "cap" be placed on the permissible size of punitive damage awards.²³⁹ Although there are several variations of the cap idea, each is premised on either a chosen ratio of punitive to compensatory awards that cannot be exceeded (1:1 or 2:1) or the imposition of a dollar figure maximum on punitive damages (\$250,000 to \$500,000).²⁴⁰ The cap concept, particularly in its "ratio limit" form, is flawed due to its rigidity. To illustrate, in some cases the compensatory award may be very low yet the conduct of the firm may be deserving of serious punishment. For example, if a broker was making unauthorized trades in an investor's account, but was caught before he had caused large losses, the compensatory award would be very low. In this situation, a large punitive award might be justified in order to deter future misconduct by the broker and to compel the firm to watch over its employees more closely.²⁴¹ Because of its inflexibility, a ratio cap

²³⁸ See Katsoris, *supra* note 20, at 1140 (suggesting that limiting judicial review to only the punitive damage portion of an award would not significantly reduce the time and cost benefits of arbitration).

²³⁹ See NASD Report, *supra* note 130, at 333-34 (advocating either a ratio limit or an absolute dollar figure limit).

²⁴⁰ See *id.*

²⁴¹ Compare *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711 (1993),

would prevent this deterrence. A dollar figure cap could also be insufficient as a deterrent and punishment if the compensatory damages are very high. In addition to these problems, a cap is unnecessary if the arbitrators follow guidelines for making the awards and the awards themselves are subject to judicial review.

Second, one prominent commentator on securities arbitration suggests that firms include an "opt out" clause in their arbitration agreements.²⁴² The opt out clause would allow one party to remove the entire case to a civil court if the other party seeks punitive damages. The theory of this proposal is that parties wanting swift arbitral justice would sue only for compensatory damages. Thus, investors could compel arbitration by limiting their claims, while brokerage firms could gain the increased procedural safeguards of courtroom litigation in a case asking for punitive damages, presumably because of the higher stakes involved and the likelihood that it is a more complex case. Although appealing at first glance, the opt out clause suffers from several defects. First, such a system brings great benefits to the brokerage firms at the expense of small claimants. A brokerage firm could effectively discourage an investor with a small compensatory claim, who cannot afford to litigate, from requesting punitive damages. As a result, the incentive for investors to file claims, provided by the possibility of a punitive damage award, would be lost. Second, instituting a procedure that necessarily involves the court system robs the parties of the advantages of speed and low cost that are central to arbitration. Finally, this procedure would further bog down a court system already overwhelmed by cases.

Third, some have suggested bifurcated proceedings in which the compensatory claim is decided by the arbitrators while the punitive claim goes directly to a judge and jury.²⁴³ Bifurcated proceedings of this type are not a sensible option. "The delay, extra cost and possibility for inconsistent or incompatible outcomes that could result from such separate procedures are hardly the panacea for a

in which a jury awarded a plaintiff \$19,000 in compensatory damages and \$10 million in punitive damages. The Supreme Court upheld the award noting that the potential gain for the defendant company, had its trickery worked, would have been close to \$10 million. *See id.* at 2722.

²⁴² See C. Evan Stewart, *Arbitrating Securities Law Claims: Can the Failed Promise Be Redeemed?*, in *SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES* 163, 178 (Edward J. Yodowitz et al. eds., 1994).

²⁴³ See Katsoris, *supra* note 20, at 1140 (noting this suggestion and rejecting it as impractical).

court system already clogged with too many other cases."²⁴⁴ In addition, bifurcation would prevent investors who cannot afford litigation from pursuing punitive damages, thereby losing the benefit of deterrence that these claims and awards bring. Knowing that in most cases the extent of their liability will be only compensatory damages, firms would have less incentive to be careful.

B. Guidelines, Written Decisions and Judicial Review

The recent Supreme Court decisions discussed in Part III.D clearly state that punitive damage awards can only be made where procedural safeguards are in place to guarantee that the size of the award does not violate the party's due process rights. In these cases, the Court declared that the opportunity for judicial review was one such safeguard.²⁴⁵ Evidence that the factfinder was given instructions on how to arrive at a proper award and that the trial court judge stated his reasons for upholding the jury's award into the record impressed the Court as providing protections which satisfy the Due Process Clause.²⁴⁶ Consistent with these decisions, a three-pronged reform of the procedure for making and contesting punitive damage awards is recommended.

First, the regulatory agencies should establish guidelines which arbitrators must follow when deciding whether to award punitive damages and how large the award should be. In *Pacific Mutual Life Insurance Co. v. Haslip*,²⁴⁷ the Court noted the significance of instructions that guided the jury on the considerations that should be weighed when determining whether to award punitive damages.²⁴⁸ In arbitration, the panelists are guided only by their personal notions of justice when faced with the question whether to award punitive damages and in what amount. Although arbitrators are usually more experienced than jurors, and thus presumably better prepared to decide whether punitive damages should be awarded and in what amount, an established set of criteria would improve the consistency and predictability of punitive awards, thereby increasing fairness in the arbitration process. The regulators should mandate that arbitrators consider a number of factors when granting an award, such as the amount at stake in the

²⁴⁴ *Id.*

²⁴⁵ See *supra* notes 231-34 and accompanying text (discussing the *Honda* case).

²⁴⁶ See *supra* notes 224-26 and accompanying text (discussing the *Haslip* case).

²⁴⁷ 499 U.S. 1 (1991).

²⁴⁸ See *id.* at 19-20.

arbitration, the defendant firm's net worth, any bad faith exhibited by the firm, and whether the firm is a repeat offender.²⁴⁹

Second, the arbitrators should be compelled to provide written reasons for any punitive damage awards they make. Meaningful judicial review of arbitral awards under the current system is practically impossible because arbitrators do not provide reasons for their decisions.²⁵⁰ As noted by the Court in *Honda Motor Co. v. Oberg*,²⁵¹ judicial review of a punitive damage award is an important element of due process.²⁵² Moreover, a punitive damage award will more effectively deter similar misconduct by other brokerage firms if they are aware of the specific wrongdoing committed by the penalized firm. However, requiring arbitrators to draft reasons for their awards imposes certain costs on the arbitration system.²⁵³ The costs include (1) discouraging some qualified people from serving as arbitrators because they do not have time to draft opinions, (2) risking that the arbitrators will draft poor quality opinions, and (3) reducing the speed of the arbitration process. Although these concerns are valid reasons for not forcing arbitrators to draft opinions in each case, they are not persuasive if arbitrators are only required to state their reasons for awarding punitive damages for purposes of judicial review. Judicial review can be performed without "a judge-like scholarly" arbitral opinion.²⁵⁴ Furthermore, because punitive damages are awarded so infrequently (in approximately two percent of the cases), a brief explanation for the award in these cases should neither significantly slow the process nor deter individuals from becoming arbitrators.

Third, any punitive damage award made by arbitrators should be subject to review by a court.²⁵⁵ Because, under the procedures recommended here, the arbitrators' award would be premised on guidelines established by the regulatory agencies and justified with written reasons, judicial review should work effectively. The opportunity for judicial review would satisfy the Court's concern in

²⁴⁹ See, e.g., *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711, 2722 (1993) (noting the importance of these criteria when evaluating the propriety of a punitive damage award).

²⁵⁰ See *supra* note 31 and accompanying text.

²⁵¹ 114 S. Ct. 2331 (1994).

²⁵² See *id.* at 2335, 2341.

²⁵³ See Katsoris, *supra* note 20, at 1133-34 (noting these costs to the arbitration system, but concluding that they are worthwhile).

²⁵⁴ See Stewart, *supra* note 31, at 360.

²⁵⁵ See Katsoris, *supra* note 55, at 599-600 (supporting judicial review of punitive damage awards).

Honda without severely undermining the goals of arbitration as a fast, inexpensive, and final forum for dispute resolution. Under this approach the arbitrator would hear the entire case and determine all the appropriate damages, thereby maintaining the speed and cost savings of the arbitral method of dispute resolution. The principle of finality would also be largely preserved because the compensatory damage award would not be subject to judicial review. In addition, the cost of appealing the arbitrators' ruling to a court, and the policy of courts to uphold arbitrators' awards in most cases, should discourage firms from filing frivolous appeals.

By leaving the power to award punitive damages with the arbitrators, the benefits punitive damages provide for the governance of the securities industry are also retained. The threat of a monetary punishment will motivate firms to oversee their employees' activities more closely. It will also encourage firms to settle disputes that do arise with investors, instead of fighting each claim, thereby increasing the speed and reducing the overall costs of dispute resolution. Moreover, including punitive damages as a potential remedy in arbitration supports the notion that, by agreeing to arbitrate, investors are not submitting to a form of dispute resolution in which the "deck is stacked" against them.

CONCLUSION

With *Mastrobuono*, the Supreme Court had an opportunity to dictate significant change in securities arbitration. The Court failed to do so, however, and instead rendered a narrowly tailored, limited opinion. The fate of punitive damages in securities arbitration remains, then, in the hands of the regulatory agencies. In determining how to proceed, the regulatory agencies need to balance the benefits punitive damages bring to investors and to the governance of the industry as a whole against the due process rights of the brokerage firms. By accepting the proposals in this Comment, and subjecting punitive damage awards to judicial review after requiring arbitrators to follow established guidelines and give written reasons for the awards, the regulators will successfully address the demands of investors, brokerage firms, and the Constitution.