

Nova Law Review

Volume 19, Issue 3

1995

Article 8

Punitive Power: Securities Arbitrators Need It

Darren C. Blum*

*

Copyright ©1995 by the authors. *Nova Law Review* is produced by The Berkeley Electronic Press (bepress). <https://nsuworks.nova.edu/nlr>

Punitive Power: Securities Arbitrators Need It

Darren C. Blum

Abstract

The major advantages of arbitration are that the disputes are resolved more expeditiously and cost effectively than in court.

KEYWORDS: power, punitive, securities

Punitive Power: Securities Arbitrators Need It

TABLE OF CONTENTS

I.	INTRODUCTION	1063
II.	CONFLICT AMONG THE COURTS	1065
	A. <i>Mastrobuono v. Shearson Lehman Hutton, Inc.:</i> <i>The Minority View</i>	1065
	B. <i>J. Alexander Securities, Inc. v. Mendez:</i> <i>The Majority View</i>	1068
	C. <i>The Mendez Dissent</i>	1072
III.	THE SUPREME COURT'S DECISION IN <i>MASTROBUONO</i>	1072
IV.	ARBITRATOR USE OF THE POWER TO AWARD PUNITIVE DAMAGES	1074
	A. <i>Accomplishing the Purposes of Punitive Damages</i>	1074
	B. <i>Safeguards</i>	1075
V.	RECOMMENDATIONS	1078
VI.	CONCLUSION	1080

I. INTRODUCTION

If a man shall steal an ox, or a sheep, and kill it, or sell it; he shall restore five oxen for an ox, and four sheep for a sheep.¹

Arbitration is an effective alternative method to litigation which alleviates the tremendous strain currently burdening our judicial system.² Disputes submitted to arbitration are resolved by arbitrators.³ A model arbitrator is impartial, knowledgeable, and well versed in the area of controversy.⁴ A popular type of dispute frequently resulting in arbitration is securities transactions.⁵

1. *Exodus 22:1* (King James).

2. Anthony M. Sabino, *Awarding Punitive Damages In Securities Industry Arbitration: Working For A Just Result*, 27 U. RICH. L. REV. 33, 33 (1992).

3. SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, *ARBITRATION PROCEDURES*, at 3 (1989).

4. *Id.*

5. *Id.*

The major advantages of arbitration are that the disputes are resolved more expeditiously and cost effectively than in court.⁶ Additionally, the arbitrator's decision is final and binding, with limited grounds for reversal.⁷ Therefore, time and money, the two most important concerns of investors and brokerage firms, are saved.⁸

Until recently, one of the uncertainties in securities arbitration was the power of the arbitrators to award punitive damages.⁹ Punitive damages are defined as compensation in "excess of actual damages" and are awarded "only in instances of malicious and willful misconduct."¹⁰ The dual purpose of punitive damages is to punish the wrongdoer and to deter similar future misconduct.¹¹ The question of whether securities arbitrators have the power to award punitive damages was decided on March 6, 1995, when the United States Supreme Court decided *Mastrobuono v. Shearson Lehman Hutton, Inc.*,¹² holding that, under the parties' agreement, arbitrators had punitive power.¹³ However, the decision, based on contractual interpretation, did not universally empower securities arbitrators with the power to award punitive damages. Rather, the Court stated that contracting parties are free to agree to include punitive damages within the arbitrable issues.¹⁴ The *Mastrobuono* decision will affect not only investors and brokerage firms, but also attorneys who practice in this complicated area of law.

This article first analyzes two recent cases which have conflicting holdings and rationales concerning the power of arbitrators to award punitive damages.¹⁵ Next, the article discusses how the United States Supreme Court seemingly resolved this conflict. Additionally, the article explains some of the policy reasons behind giving securities arbitrators the power to award punitive damages. Finally, the article concludes with

6. *Id.*

7. *See infra* note 129.

8. *See* Sabino, *supra* note 2, at 33.

9. Marilyn B. Cane, *Punitive Damages in Securities Arbitration: The Interplay of State and Federal Law (Or a Smaller Bite of the Big Apple)*, 1993 J. DISP. RESOL. 153, 153.

10. BARRON'S LAW DICTIONARY 117 (3d ed. 1991).

11. *Id.*

12. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, No. 94-18, 1995 WL 86555 (Mar. 6, 1995).

13. *Id.* at *6.

14. *Id.* at *4.

15. *See generally Mastrobuono*, 20 F.3d 713 (7th Cir.), *cert. granted*, 115 S. Ct. 305 (1994), *and rev'd*, No. 94-18, 1995 WL 86555 (Mar. 6, 1995); *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr. 2d 826 (2d Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994).

recommendations on how the various arbitral forums can improve the arbitration system.

II. CONFLICT AMONG THE COURTS

The Second and Seventh Circuits of the United States Court of Appeals have held that securities arbitrators do not have the power to award punitive damages.¹⁶ This was in direct conflict with the majority view, and, prior to the United States Supreme Court's decision in *Mastrobuono*, was the cause of the legal inconsistency that baffled many arbitrators, judges, and attorneys.¹⁷

A. *Mastrobuono v. Shearson Lehman Hutton, Inc.: The Minority View*

The Seventh Circuit's most recent decision concerning the issue of punitive damages in securities arbitration was *Mastrobuono v. Shearson Lehman Hutton, Inc.*¹⁸ In 1985, the plaintiff-appellants, Antonio and Diana Mastrobuono, opened a securities account with Shearson Lehman Hutton, Inc. (Shearson).¹⁹ The client agreement between the plaintiffs and Shearson provided, in relevant part: "This agreement . . . shall be governed by the laws of the State of New York [A]ny controversy arising out of or relating to [the plaintiffs'] accounts . . . shall be settled by arbitration"²⁰

In 1989, the plaintiffs sued Shearson in the United States District Court for the Northern District of Illinois, claiming unauthorized trading, churning, and breach of fiduciary duty.²¹ Plaintiffs requested compensatory as well as punitive damages;²² however, Shearson successfully moved to compel arbitration before the National Association of Securities Dealers ("NASD").²³

16. See, e.g., *Mastrobuono*, 20 F.3d at 714; *Barbier v. Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2d Cir. 1991).

17. Cf. *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988).

18. 20 F.3d 713.

19. *Id.* at 715.

20. *Id.* Additionally, the agreement provided the plaintiff with the choice of the arbitral forum. *Id.*

21. *Id.*

22. *Mastrobuono*, 20 F.3d at 715.

23. *Id.*

After hearing the arguments of both sides, the arbitrators awarded the plaintiffs \$159,327.00 in compensatory damages and \$400,000.00 in punitive damages.²⁴ Shearson filed a motion in the district court to vacate the award of punitive damages,²⁵ arguing that New York law, the governing law of the client agreement, denied arbitrators the power to award punitive damages.²⁶ The district court granted Shearson's motion and vacated the punitive damages award.²⁷ The plaintiffs appealed, and the United States Court of Appeals for the Seventh Circuit affirmed.²⁸

First, the court of appeals rejected the plaintiffs' argument that the district court violated the scope of review imposed by the Federal Arbitration Act ("FAA").²⁹ The court explained that "the FAA permits a court to vacate an award '[w]here the arbitrators exceeded their powers.'"³⁰ Furthermore, in order to support the decision, the court relied heavily upon the Second Circuit's rationale in *Barbier v. Shearson Lehman Hutton, Inc.*³¹ The *Barbier* court stated that when arbitrators are not empowered with the ability to award punitive damages due to a choice of law provision in the parties' agreement, then the arbitrators would exceed their powers by awarding such damages.³² Therefore, in the instant case, the court of appeals held that the lower court properly reviewed the arbitrator's authority to award punitive damages.³³

The court then examined the arbitration agreement itself and recognized that it contained a New York choice of law provision.³⁴ Under New York law, arbitrators cannot award punitive damages; this is referred to as the *Garrity* rule.³⁵ The plaintiffs' argument that the FAA preempts the *Garrity* rule, and thereby authorizes the arbitrators to award punitive damages, was rejected.³⁶ The court explained that the policy supporting the FAA "is simply to ensure the enforceability, according to their terms, of private

24. *Id.*

25. *Id.*

26. *Id.*

27. *Mastrobuono*, 20 F.3d at 716.

28. *Id.* at 719.

29. *Id.* at 716.

30. *Id.* (quoting 9 U.S.C. § 10(a)(4) (1988)).

31. 948 F.2d 117 (2d Cir. 1991).

32. *Id.* at 122.

33. *Mastrobuono*, 20 F.3d at 716.

34. *Id.*

35. *Id.* (citing *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976)).

36. *Id.*

agreements to arbitrate.³⁷ Therefore, following the rationale of *Volt*,³⁸ the court enforced the parties' agreement according to its terms, which was to arbitrate all of their controversies under New York law.³⁹

The Seventh Circuit continued its reasoning by examining a case similar to *Mastrobuono*, which was decided in the same circuit ten years earlier.⁴⁰ In *Pierson*,⁴¹ a brokerage agreement also contained a New York choice of law provision.⁴² The court reasoned that although the Piersons may not have realized that the wording of the arbitration clause precluded a punitive damage award, they could not "use their failure to inquire about the ramifications of that clause to avoid the consequences of agreed-to arbitration."⁴³ Relying on *Pierson*, the *Mastrobuono* court concluded that the choice of law provision incorporated the *Garrity* rule.⁴⁴ Therefore, since New York law applied, and securities arbitrators did not have the power to award punitive damages in New York, the court found that the arbitrators exceeded their authority.⁴⁵

The Mastrobuonos then argued that the arbitration rules of the NASD clearly authorized arbitrators to award punitive damages.⁴⁶ The court disposed of this argument by explaining that New York law applies no matter which arbitral forum the plaintiffs happen to choose.⁴⁷ The court explained that the parties did not intend for the availability of punitive damages to vary with the plaintiffs' choice of arbitration rules.⁴⁸ Therefore, the arbitration agreement, signed by the Mastrobuonos, enforced the *Garrity* rule whether the arbitration occurred at the New York Stock Exchange ("NYSE"), NASD, or any other arbitral forum.⁴⁹

The Seventh Circuit's decision in *Mastrobuono* reinforced the minority view that securities arbitrators did not have the power to award punitive damages. The Second Circuit was the only other federal court of appeals

37. *Id.* (quoting *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 476 (1989)).

38. *Volt*, 489 U.S. 468 (1989).

39. *Mastrobuono*, 20 F.3d at 717.

40. *Id.* (citing *Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984)).

41. *Pierson*, 742 F.2d 334 (7th Cir. 1984).

42. *Id.* at 336.

43. *Mastrobuono*, 20 F.3d at 717 (quoting *Pierson*, 742 F.2d at 339).

44. *Id.*

45. *Id.* at 718.

46. *Id.*

47. *Id.*

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

49. *Id.*

which subscribed to this view.⁵⁰ Some of the possible reasons these two courts had for taking their stance against punitive damages will be explored later in this article.

The Mastrobuonos appealed to the United States Supreme Court. On March 6, 1995, the United States Supreme Court issued its decision in *Mastrobuono*, holding that the choice of law provision in the parties' client agreement covered the rights and duties of the parties, while the arbitration clause covered arbitration, thus giving the arbitrators the power to award punitive damages.⁵¹ The decision is analyzed in Part III of this article.

B. *J. Alexander Securities, Inc. v. Mendez: The Majority View*

Mendez was decided by a California state court of appeal.⁵² Although this case was decided at the state level, the opinion represents the majority view of the federal courts.⁵³ The majority holds that securities arbitrators have the power to award punitive damages, even though a New York choice of law provision is present.⁵⁴ In making its decision, the *Mendez* court relied upon the rationales of previous cases which were decided in the First, Ninth, and Eleventh Circuits.⁵⁵

In 1980, Signe Mendez, an elderly widow, opened a securities account with J. Alexander Securities, Inc., a brokerage firm located in Los Angeles.⁵⁶ Upon opening the account, Mendez signed a Cash Account Agreement which contained an arbitration clause for disputes, as well as a New York choice of law provision.⁵⁷

50. See, e.g., *Barbier*, 948 F.2d at 117.

51. *Mastrobuono*, 1995 WL 86555, at *6.

52. *Mendez*, 21 Cal. Rptr. 2d 826.

53. See generally *Todd Shipyards*, 943 F.2d at 1062 (relying on federal law, rather than New York law, the court held that the arbitrators had the authority to award punitive damages); *Raytheon*, 882 F.2d at 12 (upholding a punitive damage award rendered by a commercial arbitration panel, whereby the agreement expressly provided that all disputes would be settled by arbitration according to the rules of the American Arbitration Association); *Bonar*, 835 F.2d at 1387 (holding that a choice of law provision in an arbitration agreement does not deprive arbitrators of their power to award punitive damages).

54. E.g., *Todd Shipyards*, 943 F.2d at 1062; *Bonar*, 835 F.2d at 1387.

55. See *Mendez*, 21 Cal. Rptr. 2d at 829 (citing *Todd Shipyards*, 943 F.2d at 1062; *Raytheon*, 882 F.2d at 11; *Bonar*, 835 F.2d at 1387).

56. *Id.* at 826-27.

57. *Id.* at 827. The agreement stated, in pertinent part:

This agreement and its enforcement shall be governed by the laws of the State of New York Any dispute or controversy between us arising under any provision of the federal securities laws can be resolved through litigation in

A dispute arose in 1991, whereby Mendez claimed that the brokerage firm and the broker, Weber, had engaged in securities fraud, deceptive practices, churning, unsuitability, and unauthorized stock trading.⁵⁸ As a result, Mendez suffered substantial financial losses.⁵⁹ The parties agreed to arbitrate their dispute at the NASD, and hearings on the controversy were conducted in 1992.⁶⁰ The arbitrators awarded Mendez \$27,000.00 in compensatory damages, as well as \$27,000.00 in punitive damages against the firm only.⁶¹ The arbitrators explained that the firm failed to adequately supervise its employee, Weber, thereby, not meeting the required standards to assure compliance with applicable securities regulations.⁶²

The firm proceeded to the trial court and moved to correct the award pursuant to the California Code of Civil Procedure, on the grounds that the arbitrators had exceeded their powers by awarding punitive damages.⁶³ The trial court denied the motion and confirmed the award; however, the firm appealed.⁶⁴ The court of appeal affirmed and provided a thorough explanation.⁶⁵

The court held that the arbitrators were not precluded from awarding punitive damages by virtue of the New York choice of law provision.⁶⁶ The reasoning was based on the cash account agreement, which “evidenced a transaction in interstate commerce[;]” therefore, the FAA applied.⁶⁷ The court explained that the purpose of the FAA is to encourage arbitration, and the underlying principle is that any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.⁶⁸ The court refused to follow the minority view of the Second Circuit which held that state law is not preempted by federal substantive law on the issue of

the courts if the undersigned so chooses. The undersigned also understands that arbitration is available with respect to such disputes. Additionally, all other disputes or controversies between us arising out of your business or this agreement, shall be submitted to arbitration conducted under the provisions of the [rules of the NYSE or NASD], as the undersigned may elect

Id. at 827-28.

58. *Id.* at 828.

59. *Mendez*, 21 Cal. Rptr. 2d at 828.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* (referring to CAL. CIV. PROC. CODE § 1286.6(b) (1993)).

64. *Mendez*, 21 Cal. Rptr. 2d at 828.

65. *Id.* at 829.

66. *Id.*

67. *Id.* at 830.

68. *Id.* (citing *Moses H. Cone Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983)).

punitive damage awards by securities arbitrators.⁶⁹ Rather, the court concluded that the choice of law provision designates only the substantive law that the arbitrators must apply in determining whether the parties' conduct warrants an award of punitive damages; it does not deprive them of the power to award such damages.⁷⁰

The firm also contended that there was nothing in the parties' agreement which permitted punitive damages.⁷¹ The court agreed, but stated that there was also nothing in the agreement that expressly excluded the possibility of a punitive damage award either.⁷² The court held that the arbitration provision "contained in the Cash Account Agreement encompassed 'any dispute or controversy between [the parties] arising under any provision of the Federal securities laws' and 'all other disputes or controversies between [the parties] arising out of [appellant's] business or this agreement.'" ⁷³ Therefore, the court found the arbitration agreement broad enough to contemplate punitive damages.⁷⁴

The appellant then argued that the agreement to arbitrate under the rules of the NYSE or the NASD, which are silent on the issue of punitive damages, exemplified that such an award was not contemplated by the parties.⁷⁵ The court rejected this argument based on public policy which was enunciated by other federal courts that punitive damage awards clearly support arbitration as an effective method of resolving disputes.⁷⁶ The court explained that the failure of the NASD to expressly state in its rules that the arbitrators have the power to award punitive damages should not bar the availability of that remedy.⁷⁷ Therefore, in the absence of an express provision in the Cash Account Agreement or an NASD rule prohibiting an award of punitive damages, the arbitrators did not exceed their powers.⁷⁸

There was a constitutional question of due process raised by the appellant which the court also rejected.⁷⁹ The appellant, relying on a

69. *Mendez*, 21 Cal. Rptr. 2d at 830 n.7 (citing *Barbier*, 948 F.2d at 122; *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir.), *cert. denied*, 502 U.S. 1120 (1992), and *aff'd*, 989 F.2d 490 (3d Cir. 1993)).

70. *Id.* (citing *Bonar*, 835 F.2d at 1387).

71. *Id.*

72. *Id.*

73. *See id.*; *see also supra* note 55.

74. *Mendez*, 21 Cal. Rptr. 2d at 831.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 832.

79. *Mendez*, 21 Cal. Rptr. 2d at 832.

United States Supreme Court case, contended an absence of constraints upon the arbitrators and a lack of judicial review.⁸⁰ Similar arguments were also rejected by the Ninth Circuit in *Todd Shipyards Corp. v. Cunard Line, Ltd.*⁸¹

In *Todd Shipyards*, the court found that the punitive damage award rendered by an arbitration panel did not violate due process because the appellant had notice that the respondent sought punitive damages, and was given the opportunity to argue its position by presenting evidence.⁸² Relying on *Todd Shipyards*, the judge explained that the appellant did not claim that it lacked notice of Mendez's claim for punitive damages, nor that it was unable to present evidence or legal theories against such an award.⁸³ Therefore, no violation of due process occurred.⁸⁴

A California case, *Baker v. Sadick*,⁸⁵ was relied upon to quickly dispose of the lack of judicial review issue.⁸⁶ *Baker* involved a punitive damage award in a medical malpractice claim which was submitted to arbitration.⁸⁷ The court in *Baker* held that although the arbitration agreement was broad, the parties had the power to control the scope of that agreement.⁸⁸ Similarly, the parties in the instant case could have expressly agreed, in the Cash Account Agreement, to no awards of punitive damages; but they did not.⁸⁹ Consequently, the lack of judicial review argument was rejected.⁹⁰ The court of appeal upheld the punitive damage award and the California Supreme Court denied review.⁹¹ The firm then filed a petition for a writ of certiorari in the United States Supreme Court, but it was denied.⁹² Nevertheless, an interesting dissent followed the denial of certiorari.⁹³

80. *Id.* (citing *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991)).

81. 943 F.2d 1056, 1063 (9th Cir. 1991).

82. *Id.*

83. *Mendez*, 21 Cal. Rptr. 2d at 833.

84. *Id.*

85. 208 Cal. Rptr. 676 (4th Ct. App. 1984).

86. *See Mendez*, 21 Cal. Rptr. 2d at 833.

87. *See Baker*, 208 Cal. Rptr. at 678.

88. *Id.* at 684.

89. *See Mendez*, 21 Cal. Rptr. 2d at 827.

90. *Id.* at 833.

91. *Id.*

92. *Mendez*, 114 S. Ct. 2182.

93. *See id.* (Rehnquist, C.J., & O'Connor, J., dissenting).

C. *The Mendez Dissent*

Although *Mendez* was denied certiorari, a clear and concise dissenting opinion followed, evidencing much interest in settling the conflict among the lower courts.⁹⁴ After giving a brief description of the facts in *Mendez*, Justice O'Connor recognized that the decision followed the majority view which holds that the FAA preempts state law prohibitions of punitive damages in arbitration.⁹⁵ However, she explained that the decision was directly contrary to the views of the Second and Seventh Circuits, which held that state law was not preempted by federal substantive law for the purpose of an arbitrator's power to award punitive damages.⁹⁶ Realizing that the FAA was created to avoid these differences, she would have granted certiorari to solve the recurring problem.⁹⁷

III. THE SUPREME COURT'S DECISION IN *MASTROBUONO*

One of the functions of the United States Supreme Court is to settle conflicting decisions among the lower federal courts, especially when the issue is of great public importance.⁹⁸ The cases analyzed above demonstrate a direct conflict among the federal courts concerning the power of an arbitrator to award punitive damages.⁹⁹ Additionally, since millions of dollars are awarded in punitive damages in securities arbitrations every year, the issue is of great public importance.¹⁰⁰ This placed the Supreme Court in an excellent position to rule on the issue. The Court, following the lead of Justice O'Connor and the Chief Justice, realized that it was not up to the legislature or the arbitral forums to resolve this issue; therefore, the *Mastrobuono*'s petition for certiorari was granted.¹⁰¹

On March 6, 1995, by an eight to one decision,¹⁰² the Supreme Court reversed the Seventh Circuit's ruling in *Mastrobuono* and granted arbitrators

94. See *Mendez*, 114 S. Ct. 2182 (Rehnquist, C.J., & O'Connor, J., dissenting).

95. *Id.* (citing *Todd Shipyards*, 943 F.2d at 1056; *Bonar*, 835 F.2d at 1378).

96. *Id.* (citing *Mastrobuono*, 20 F.3d at 713; *Barbier*, 948 F.2d at 117).

97. *Id.*

98. ROBERT L. STERN ET AL., SUPREME COURT PRACTICE, § 4.2, at 165 (7th ed. 1993).

99. See generally *Mastrobuono*, 20 F.3d at 713; *Mendez*, 21 Cal. Rptr. 2d at 826.

100. See generally *Punitive Award Survey*, SEC. ARB. COMMENTATOR, at 3 (May 1993) [hereinafter SAC].

101. *Mastrobuono*, 115 S. Ct. 305.

102. Justice Clarence Thomas was the lone dissenter. See *Mastrobuono*, 1995 WL 86555, at *6 (Thomas, J., dissenting).

the power to award punitive damages.¹⁰³ The majority opinion was written by Justice Stevens and the central theme was that the FAA ensures that arbitration agreements will be enforced according to their terms.¹⁰⁴ However, the New York choice of law provision contained in the parties' agreement created an ambiguity.¹⁰⁵ Applying common law rules of contractual interpretation, the Court construed the ambiguous language against the interest of the party that drafted it; in this case, as in most, that party was the brokerage firm.¹⁰⁶

The Court then examined some of the NASD rules, as well as an NASD manual given to the arbitrators which included a section permitting the consideration of punitive damages.¹⁰⁷ The holding was also based on the belief that it was unlikely that the plaintiffs were actually aware of the New York choice of law provision which prohibited punitive damages in arbitration.¹⁰⁸ However, it was noted that parties can structure their arbitration agreements as they see fit and specify by contract the rules under which that arbitration will be conducted.¹⁰⁹

Although the decision appears to be a victory for disgruntled investors, the Court's analysis left many issues unresolved. First, brokerage firms now may consider rewording their customer agreements in order to clearly state the unavailability of punitive damages. However, this could lead to the issue of whether the agreements are contracts of adhesion, thereby making the provisions unenforceable. Furthermore, the NASD rules provide, *inter alia*, that no predispute arbitration agreement shall limit the ability of the arbitrators to make any award.¹¹⁰ The Court recognized this rule; however, it was inapplicable in *Mastrobuono* because the agreement was executed before the effective date of the rule.¹¹¹

Additionally, before individuals contract away an "important substantive right" such as punitive damages, they should be made aware of the implications of what they are doing.¹¹² A related issue pertains to the

103. *Id.*

104. *Id.* at *4.

105. *Id.* at *5.

106. *Id.*

107. *Mastrobuono*, 1995 WL 86555, at *5.

108. *Id.*

109. *Id.* at *3 (citing *Volt*, 489 U.S. at 479).

110. See NATIONAL ASS'N OF SECURITIES DEALERS, RULES OF FAIR PRACTICE ¶ 2171, Rule 21(f)(4) (1993).

111. Rule 21(f)(4) only applies to agreements signed after September 7, 1989. See *id.* Rule 21(f)(5). The *Mastrobuonos* signed their agreement in 1985.

112. See *id.* at *5.

proper standard of review to be applied in arbitration appeals as to the scope of an arbitration.¹¹³ Considering these unanswered questions, it will be interesting to note the impact this decision will have on securities arbitration.

IV. ARBITRATOR USE OF THE POWER TO AWARD PUNITIVE DAMAGES

Many factors must be considered in empowering securities arbitrators with the authority to award punitive damages. First, the use of punitive power must be used only in instances in which the purposes of such damages are served. Next, there must be a mechanism to ensure that safeguards exist in order to prevent unjust awards. Finally, use of the punitive power must be done in a way that keeps the arbitration process fair and efficient.

A. *Accomplishing the Purposes of Punitive Damages*

Punitive damages, as stated earlier, serve two purposes: to punish the wrongdoer and to deter similar future misconduct.¹¹⁴ Members of the securities industry must fear this type of punishment in order to help reduce the amount of unscrupulous and malicious conduct that plagues this otherwise professional field.¹¹⁵

The nature of the securities industry creates a fiduciary duty bestowed upon the individual brokers and firms.¹¹⁶ The brokers give financial advice to their clients and then invest their money.¹¹⁷ These brokers are compensated on a commission basis which may cause a conflict of interest between themselves and their clients.¹¹⁸ The more frequently the client buys and sells securities based on representations made by their broker, the greater the commission the broker and his firm will earn. This conflict sometimes leads to fraudulent conduct by the broker in order to generate commissions.¹¹⁹

113. The Court recently granted certiorari on this issue in *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 634 (1994).

114. See BARRON'S LAW DICTIONARY, *supra* note 10, at 117.

115. Brief for Respondent at 14, *In re Dreyfus Serv. Corp.*, 584 N.Y.S.2d 483 (1992) (No. 11629/90).

116. *Id.*

117. *Id.*

118. *Id.*

119. This type of misconduct is known as "churning."

If punitive damages are awarded against a broker or a firm for fraudulent or grossly negligent conduct, the firm will surely eliminate such behavior.¹²⁰ Conversely, if arbitrators had no authority to award punitive damages, firms would lack incentive to strictly monitor their brokers' behavior.¹²¹ Therefore, the misconduct would continue if the threat of monetary punishment were limited to the amount actually lost.¹²² Hopefully, the Supreme Court's decision in *Mastrobuono* will help in this regard.

In addition to the deterrent effect of punitive damages, the threat of such damages motivates settlement of securities disputes.¹²³ For instance, if a firm realizes that the arbitrator lacks the authority to award punitive damages, thereby only exposing the firm to limited liability, the likelihood of a fair settlement offer is poor.¹²⁴ Moreover, the firm recognizes that if the settlement offer is refused, then the investor must incur continued expenses, such as forum fees, expert witnesses, and attorney's fees.¹²⁵ These factors unfairly influence the investor in accepting a low settlement.

To the contrary, the empowerment of arbitrators with the authority to award punitive damages should motivate firms in settlement negotiations.¹²⁶ The threat of punitive damages, accompanied by the fear of the unknown amount which could be awarded, should help end the disputes in a quicker and more equitable manner.¹²⁷ Because the arbitrators now have the power to grant punitive damages, the entire arbitration process benefits, even if the power is not actually exercised.

B. Safeguards

The most popular argument used in opposing an arbitrator's power to award punitive damages is the lack of judicial review.¹²⁸ This stance is in response to the narrow and limited grounds for vacating an award.¹²⁹

120. Brief for Respondent at 14, *Dreyfus* (No. 11629/90).

121. *Id.*

122. *Id.*

123. *Id.* at 18.

124. *Id.*

125. Brief for Respondent at 18, *Dreyfus* (No. 11629/90).

126. *Id.*

127. *Id.* at 19.

128. See, e.g., *Mendez*, 21 Cal. Rptr. 2d at 832.

129. 9 U.S.C.A. § 10(a) (West Supp. 1994). The statute permits an award to be vacated only:

- (1) Where the award was procured by corruption, fraud, or undue means.

Although this argument is sensible, no court has held that the limited judicial review given to arbitral awards denies the arbitration participants due process.¹³⁰ Therefore, this argument consistently fails.¹³¹

The fear of runaway arbitrators continuously awarding punitive damages is another argument that is frequently employed by parties who oppose the arbitrators power to award such damages.¹³² This theory evolved from the court's reasoning in *Garrity v. Lyle Stuart, Inc.*¹³³ In *Garrity*, the court observed that unpredictable punitive damage awards may occur as a result of the lack of guidelines for arbitral awards, as well as the limited judicial review of the awards.¹³⁴ Almost twenty years have passed since *Garrity*, and the statistics now show that there is no need to fear that arbitrators will abuse their power in granting punitive damages.¹³⁵

In 1991, an extensive statistical analysis on this issue was written by the Public Investors Arbitration Bar Association.¹³⁶ The study, conducted from June 1987 to December 1990, showed that out of approximately 1800 arbitration awards favoring investors, there were only forty-four punitive damage awards.¹³⁷ The low frequency of the punitive damage awards

-
- (2) Where there was evident partiality or corruption in the arbitrators, or either of them.
 - (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
 - (4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.
 - (5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

Id.

130. Reply Brief for Respondent at 6, *Dreyfus* (No. 11629/90).

131. See, e.g., *Mendez*, 21 Cal. Rptr. 2d at 832-33.

132. See, e.g., *Todd Shipyards*, 943 F.2d at 1061; *Raytheon*, 882 F.2d at 8.

133. 353 N.E.2d 793 (N.Y. 1976).

134. *Id.* at 796.

135. See generally Stuart C. Goldberg, *1991 Report Of The Public Investors Arbitration Bar Association As To The Authority Of Arbitrators To Award Punitive Damages In Securities Arbitration*, 1991 PUB. INVESTORS ARB. B. ASS'N 1; see also SAC, *supra* note 100.

136. See generally Goldberg, *supra* note 135.

137. *Id.* at 109-10.

demonstrates the arbitrators' reluctance to award such damages, unless warranted by the situation.¹³⁸

Additionally, a similar study was performed by the Securities Arbitration Commentator, which was published in May of 1993.¹³⁹ This study emphasized the proportionality ratios of punitive damage awards to their compensatory damage counterpart.¹⁴⁰ The results showed that an overwhelming majority of the awards fell into the 3:1 ratio; a fair and equitable calculation.¹⁴¹ However, no exact line exists between an acceptable ratio and an unacceptable one; it is a matter of judgment.¹⁴²

No perfect formula exists in determining the size of a punitive damage award.¹⁴³ However, the Fifth Circuit Court of Appeals offered guidance in *Miley v. Oppenheimer & Co.*¹⁴⁴ The court concluded that three times the compensatory damage award is a proper guideline in determining the amount of punitive damages that should be awarded in a churning case.¹⁴⁵

Furthermore, the Supreme Court has upheld punitive damage awards that have exceeded the 3:1 ratio.¹⁴⁶ For instance, in *Pacific Mutual Life Insurance Co. v. Haslip*,¹⁴⁷ a punitive damage award which was four times the amount of the compensatory damages was upheld.¹⁴⁸ Additionally, in *TXO Production Corp. v. Alliance Resources Corp.*,¹⁴⁹ the Court upheld a \$10,000,000.00 punitive damage award when the compensatory damages were only \$19,000.00, a ratio of approximately 526:1.¹⁵⁰ Although these two cases did not involve arbitration, they directly involved due process limitations on awards of punitive damages.¹⁵¹

The Supreme Court's decision in *Mastrobuono*, based on principles of contractual interpretation, may not have alleviated all of the fears regarding

138. *Id.* at 110.

139. *See generally* SAC, *supra* note 100.

140. *Id.* at 4.

141. *Id.* at 5. Additionally, only 12% of the awards exceeded the 3:1 ratio. *Id.*

142. *Id.*

143. Goldberg, *supra* note 135, at 84.

144. 637 F.2d 318 (5th Cir.), *reh'g denied*, 642 F.2d 1210 (1981).

145. *Id.* at 332.

146. *See, e.g.*, *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711 (1993); *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991).

147. 499 U.S. 1.

148. *Id.* at 24.

149. 113 S. Ct. 2711.

150. *Id.* at 2723.

151. *See Haslip*, 499 U.S. at 9-15; *see also* *TXO Production v. Alliance Resources: The "Promise" Fades—Last Word on Punitives?*, SEC. ARB. COMMENTATOR, June 1993, at 2.

arbitrators abusing their power in awarding punitive damages. The court made no mention of delineating an acceptable measure of punitive damages, such as the general 3:1 ratio of punitive damages to compensatory damages.¹⁵² The studies mentioned above show that the arbitrators generally follow this guideline without expressly being told to do so.¹⁵³ The Court could have expressed its opinion of whether this practice is fair and equitable, but it did not do so.

V. RECOMMENDATIONS

Now that the Supreme Court has ruled in favor of arbitrators having the authority to award punitive damages despite the presence of a New York choice of law provision in securities client agreements, the arbitral forums should implement guidelines and procedures for all to follow.¹⁵⁴ This would help to ensure that the punitive awards do not violate due process.¹⁵⁵ Moreover, these procedures will create a realistic image that the arbitrators award such damages fairly and reasonably.¹⁵⁶

First, the forums should require that the arbitration panel write out an explanation on why it awarded punitive damages.¹⁵⁷ This will facilitate any appeal of the ruling by notifying the appellate decision-maker of the reasoning for the award.¹⁵⁸ Furthermore, the wrongdoer, as well as the public, will know exactly why the award is being rendered, and this will hopefully deter similar misconduct.¹⁵⁹ Unfortunately, this requirement has not been created by any forum, although the NASD is considering it.¹⁶⁰

152. See, e.g., *Miley*, 637 F.2d at 332.

153. See, e.g., *Goldberg*, *supra* note 135, at 110.

154. See generally NATIONAL ASS'N OF SECURITIES DEALERS, INC., NOTICES TO MEMBERS, July 1994 at 319-43 [hereinafter NASD].

155. *Id.* at 334.

156. *Id.*

157. *Id.* at 330.

158. *Id.*

159. NASD, *supra* note 154, at 330.

160. See *id.* (citing the NASD Code of Arbitration Procedure, § 41 (1992), which only requires that the awards be in writing and include the names of the parties and counsel, a summary of the issues, the relief requested and awarded, a statement of issues resolved, and other names and dates). Similarly, the American Arbitration Association only requires that the awards be in writing, signed by a majority of the arbitrators, and that they include a statement regarding the disposition of statutory claims. AMERICAN ARBITRATION ASS'N, SECURITIES ARBITRATION RULES § 42 (1987).

Next, the party against whom the punitive damages are rendered should reserve the right to appeal the punitive portion of the award.¹⁶¹ As described earlier in this article, the current arbitration system offers a limited right to appeal, which courts interpret narrowly.¹⁶² Therefore, the appeal should include not only the amount of the award, but the actual decision to award punitive damages itself.¹⁶³

This appeals process must not take place in the court system because that would circumvent the original purpose of submitting to arbitration.¹⁶⁴ Rather, the appellate body should consist of three individuals who are selected from a pool of arbitrators who are experienced in securities cases involving punitive damages.¹⁶⁵ The appellate panel should only vacate awards in which the arbitrators' decision below was clearly erroneous.¹⁶⁶ This system will serve as a check on the arbitrators' power to award punitive damages, and at the same time, uphold the integrity of the entire arbitration process.

The purpose of punitive damages is not to provide a windfall to the plaintiff or plaintiffs' counsel.¹⁶⁷ Therefore, the arbitral forums should require that a portion of each punitive damage award be given to an appropriate entity.¹⁶⁸ For instance, if fifty percent of all punitive awards were dispersed to groups in need of the money, then every year millions of dollars could be generated to help those groups tremendously.¹⁶⁹ The money received could go, for example, to the arbitral forum where the hearings took place, the state or federal courts, or even to the plaintiffs' favorite charity.¹⁷⁰ In fact, some states already have this procedure in place for punitive damages awarded in court.¹⁷¹

161. *Id.*

162. *See supra* note 129.

163. NASD, *supra* note 154, at 331.

164. *See Sabino, supra* note 2, at 33.

165. NASD, *supra* note 154, at 331.

166. *Id.*

167. *See id.* at 334 (stating that the purpose of awarding punitive damages is to punish those who purposefully harm the investing public for their own personal gain); *see also* BARRON'S LAW DICTIONARY, *supra* note 10, at 117.

168. NASD, *supra* note 154, at 334.

169. *See Goldberg, supra* note 135, at 7 (stating that over \$9,000,000 was awarded in punitive damages in securities arbitrations between June 1987 and Dec. 1990). *Id.*

170. NASD, *supra* note 154, at 334.

171. *Id.* (citing COLO. REV. STAT. § 13-21-102(4) (1992); FLA. STAT. ANN. § 768.73 (West Supp. 1993); MO. REV. STAT. § 537.675 (1991)).

Even though the Supreme Court ruled in favor of empowering securities arbitrators to award punitive damages, the arbitral forums must further recognize the need to improve and expand the system. Implementing the recommendations mentioned above would ensure equity and fairness within the arbitration process.¹⁷²

VI. CONCLUSION

The number of securities disputes submitted to arbitration every year is continuously rising.¹⁷³ This is mainly attributed to the arbitration agreements which are usually contained in customer account forms, which public investors sign upon the opening of their securities account.¹⁷⁴ In 1987, the Supreme Court, in *Shearson/American Express, Inc. v. Mc-Mahon*,¹⁷⁵ held that these agreements are legally enforceable and are supported by public policy which strongly favors arbitration.¹⁷⁶ The Supreme Court, in deciding *Mastrobuono*, apparently took into consideration the brokerage firms' success in closing the road to the courthouse and thereby detouring disgruntled customers to arbitration. Although the decision resolved the issue of whether the arbitrators in that case had the power to award punitive damages, the decision was more limited than what would have been desired.

The Court should have universally empowered the arbitrators with the authority to award punitive damages. The Court could have relied on the rationale that the punishment and deterrent purposes of such damages would be achieved, thus creating a more professional atmosphere among the numerous securities firms and their employees. Additionally, the Court could have recognized that although lacking strict guidelines, arbitrators have yet to exemplify bad faith or corruption in awarding punitive damages.¹⁷⁷

The brokerage firms will still have the ability to avoid a punitive damage award being rendered against them. The Court has held that under the FAA, "parties are generally free to structure their arbitration agreements

172. *Id.*

173. See NASD Chart, *Self Regulatory Organization Arbitration Filings, 1980-93* (on file with author).

174. Stuart C. Goldberg, PIABA'S 1991 PUBLIC INVESTOR RECOVERY GUIDE AND ARBITRATOR SOURCE BOOK TO STOCKBROKER FRAUD AND SECURITIES ARBITRATION at ix (1991).

175. 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987).

176. *Id.* at 242.

177. See Goldberg, *supra* note 135, at 110.

as they see fit."¹⁷⁸ Therefore, if the brokerage firms use plain and clear language which expressly prohibits punitive damages as a remedy under the arbitration contract, then the arbitrators would not have the ability to award such damages.¹⁷⁹

The majority view empowered arbitrators with the authority to award punitive damages, even when a New York choice of law provision was present.¹⁸⁰ The minority view, which held that arbitrators lack such powers, has apparently now been overruled by the Supreme Court's decision in *Mastrobuono*.¹⁸¹ The Second and Seventh Circuits were the only federal circuit courts which subscribed to the minority view.¹⁸² Their jurisdiction encompasses New York and Chicago, home to many large securities firms and the markets in which they trade. Thus, the Supreme Court's decision should have great impact on the securities industry. However, the attack on the securities arbitrators' power to award punitive damages will continue.

Darren C. Blum

178. *Volt*, 489 U.S. at 479 (Brennan, J., dissenting).

179. E. Allan Farnsworth, *Punitive Damages in Arbitration*, 20 STETSON L. REV. 395, 409 (1991); see also *Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc.*, 776 F.2d 269 (11th Cir. 1985). However, if the parties agree to arbitrate according to the NASD rules, they will not be able to limit the arbitrators' ability to award punitive damages. See *supra* note 110.

180. See, e.g., *Todd Shipyards*, 943 F.2d at 1062; *Bonar*, 835 F.2d at 1387; *Mendez*, 21 Cal. Rptr. 2d at 829.

181. See *Mastrobuono*, 1995 WL 86555.

182. See *supra* note 16.