Defining Due Process Down: Punitive Awards and Mandatory Arbitration of Securities Disputes

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I. INTRODUCTION

The modern practice of securities law is, in many respects, coextensive with the practice of securities industry arbitration. In no small measure, brokers and dealers in the securities industry have seized upon arbitration's ability to deliver less expensive, more efficient, and authoritative resolutions of disputes with customers than does the public court system.[1] Customer agreements that do not contain boilerplate language requiring that all disputes be submitted to arbitration are now the exception to the rule.[2] As a result, "in the new era, arbitration is suddenly everywhere."[3] Just a

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[1] *See* Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265, 280 (1995) (citing H.R. REP. No. 97-542, at 13 (1982) (stating that "[t]he advantages of arbitration are many: it is usually cheaper and faster than litigation")); Paul Lansing & John D. Bailey, *The Future of Punitive Damage Awards in Securities Arbitration Cases After* Mastrobuono, 8 DEPAUL BUS. L.J. 201, 205-06 (1996). Lansing and Bailey discuss a study of the benefits of arbitration in the securities industry that was commissioned by the Securities and Exchange Commission (SEC) in 1988. Three scholars surveyed securities disputes in six large brokerage firms between October 1, 1997 and June 30, 1998. Sixty-six of them were resolved in litigation and 142 were resolved through arbitration. Ultimately, they found that arbitration of securities disputes was markedly faster and more cost efficient than the public justice system. On the average, disputes resolved in arbitration required 434 days and $8,000 in legal fees to achieve a final resolution, while disputants choosing the route of traditional litigation to resolve their disputes spent, on average, $20,000 over the course of 599 days in doing so. *See id.* (citing PHILIP J. HOBLIN, JR., SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, CASES XXIII-12 (2d ed. 1992)).

[2] *See* Lorenzo Marinuzzi, *Punitive Damages in Arbitration: The Debate Continues*, DISP. RESOL. J., Summer 1997, at 67, 67 (noting that the modern era is one "where most employment contracts and securities agreements contain boilerplate language that requires both parties to submit all disputes to arbitration . . ."); *see also* Harold Brown, *Alternative Dispute Resolution: Realities and Remedies*, 30 SUFFOLK U. L. REV. 743, 745 (1997) (stating that "most stockbrokers are now governed by arbitration covenants with each brokerage firm. Almost all brokerage firms have also inserted such arbitration covenants in their customer retainer agreements.").

[3] Thomas J. Stipanowich, *Punitive Damages and the Consumerization of Arbitration*, 92 NW. U. L. REV. 1, 3, 6-7 & n.29 (1997) (observing that when the Supreme Court of the United States declared that the Federal Arbitration Act (FAA) is

decade ago, about 2,800 securities disputes were submitted to arbitration annually. That number has since expanded to almost 8,000.[4] Perhaps this advent of the widespread use of arbitration can be explained, in part, by the fact that arbitral proceedings are viewed as "[a] veritable surrogate for the public justice system."[5]

But are they? That such an extensive number of securities firms have found their place at the arbitration table has, no doubt, been the catalyst behind the resolution of disputes absent the formality, expense, and relative inefficiency of traditional litigation. Nevertheless, the increase in securities arbitration likewise has given rise to a number of questions which, at present, remain unanswered. Foremost among them, and central to modern securities arbitration, is whether securities arbitrators have the power and the authority to issue punitive damages, and if so, whether such awards must be subjected to constitutional or public policy limitations.[6] A chorus of varying responses has been generated from several different schools of thought, the consequence of which is stark discord among authorities.[7] In

substantive federal law, and thus that the FAA carries the force necessary to preempt any contrary state law, *see* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983), the Court thereby dispensed with a number of public policy limitations on the invocation of arbitration procedures, which in turn opened the door to its exceedingly widespread use).

[4] *See* Martin L. Budd, *Securities Industry Arbitration—Recent Developments, in* BROKER-DEALER REGULATION, at 119, 121 (ALI-ABA Course of Study Materials No. SC41, 1998). Between 8% and 10% of the cases filed for arbitration in the securities industry are arbitrated by the American Arbitration Association (AAA), five percent are arbitrated by self-regulatory organizations other than the National Association of Securities Dealers, Inc. (NASD), and the NASD arbitrates the remaining 85%. These figures, of course, make the NASD the "most important forum" for resolving securities disputes. *Id.*

[5] Stipanowich, *supra* note 3, at 3.

[6] *See* Isham R. Jones III, Note, *Exemplary Awards in Securities Arbitration: Short-Circuited Rights to Punitive Damages*, 1995 J. DISP. RESOL. 129, 129 (1995) (observing the strong disagreements among the federal circuit courts regarding the authority of securities arbitrators to issue punitive damages). In large part, this debate stems from the fact that a number of commentators have considered punitive damages to be the equivalent of "vindictive damages." *See, e.g.*, Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 517 (1957) (stating that "[t]he terms 'punitive,' 'vindictive,' or 'exemplary' damages and 'smart money' have been interchangeably applied to a class of money damages awarded in tort actions beyond what is needed to 'compensate' the plaintiff for his injuries").

[7] Simply because the debate over punitive damages in the securities arbitration context is a relatively new one, however, is not an indication that punitive damages in themselves are new machinery in the law. Indeed, they have been in existence for at

fact, the Securities Arbitration Task Force of the National Association of Securities Dealers, Inc. (NASD) prefaced its own position on the subject by stating that "[n]o subject has generated more widespread controversy or resulted in more polarization between investor and broker-dealer communities than the appropriateness of punitive damages in securities arbitration."[8]

Accordingly, the purpose of this Note is to survey the role that the issuance of punitive damages plays in the securities arbitration context. It contends that arbitral awards of punitive damages are inconsistent with the due process requirements of the United States Constitution. Part II traces the historical development of a jurisprudence regarding arbitral awards of punitive damages by securities arbitrators. Part III argues that such awards constitute state action, and therefore, are bound by the restrictions of the Fifth and Fourteenth Amendments. Part IV explores the relationship between punitive damages and the Due Process Clause. Finally, Part V examines and criticizes responses to the growing concern that arbitral awards of punitive damages by securities arbitrators are out of step with the Constitution. Furthermore, this Note argues that because constitutional due process requirements and punitive awards in an arbitral setting have not been reconciled, the issuance of punitive damages is inappropriate in the securities arbitration arena.

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least 4,000 years. The Code of Hammurabi, dated at c.2,000.B.C., made provisions for the award of multiple or punitive damages in some instances. *See* Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, 574 (1991). Likewise, Hittite law, the Hindu Code of Manu, and possibly Roman legal codes contained provisions for punitive damages. *See* James B. Sales & Kenneth B. Cole, Jr., *Punitive Damages: A Relic That Has Outlived Its Origins*, 37 VAND. L. REV. 1117, 1119 (1984). An English court first used the phrase "exemplary damages" to describe a jury award in excess of the plaintiff's actual injury in 1763. *See id.* (citing Huckle v. Money, 95 Eng. Rep. 768 (K.B. 1763)).

[8] David S. Ruder, *Securities Arbitration in the Public Interest: The Role of Punitive Damages*, 92 NW. U. L. REV. 69, 70 (1997) (citing ARBITRATION POLICY TASK FORCE, NATIONAL ASS'N OF SEC. DEALERS, INC., SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS 35 (1996) [hereinafter ARBITRATION POLICY TASK FORCE]).

II. THE HISTORICAL DEVELOPMENT OF A JURISPRUDENCE REGARDING ARBITRAL AWARDS OF PUNITIVE DAMAGES BY SECURITIES ARBITRATORS

The modern debate over the power of a securities arbitrator's authority to issue punitive damages begins with the decision of the New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.*[9] There it was determined, at least so far as the law of the state of New York was concerned, that the issuance of punitive damages does not fall within the scope of an arbitrator's authority, even in those cases in which the parties had entered into an arbitration agreement expressly providing for arbitral awards of punitive damages.[10] But the question was far from settled. The *Garrity* decision sparked a firestorm of debate, especially among the lower federal courts.[11] It was at long last that the Supreme Court of the United States attempted to resolve the issue of arbitral awards of punitive damages in its decision in *Mastrobuono v. Shearson Lehman Hutton, Inc.*[12] But this decision proved to be of little comfort for those seeking certainty in the law of securities arbitration.[13] The Court's *Mastrobuono* opinion left a number of questions unanswered, and generated several more in the process. This Part discusses

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[9] 353 N.E.2d 793 (N.Y. 1976).

[10] *See id.* at 794 ("Since enforcement of an award of punitive damages as a purely private remedy would violate strong public policy, an arbitrator's award which imposes punitive damages should be vacated.").

[11] *Compare* Fahnestock & Co. v. Waltman, 935 F.2d 512, 518-19 (2d Cir. 1991) (holding that unless the parties to a securities arbitration agreement expressly provided for arbitral awards of punitive damages in their contract, securities arbitrators were precluded from issuing them, even in the absence of a New York choice-of-law clause) *with* Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1061-63 (9th Cir. 1991) (upholding an arbitral award of punitive damages even though the parties had selected the law of New York as the controlling authority over their disagreements, and thus the rule of *Garrity*, 353 N.E.2d at 794, prohibiting arbitral awards of punitive damages, on grounds that the parties' agreement had also adopted the AAA's broad remedial provisions to govern any disputes regarding arbitration).

[12] 514 U.S. 52 (1995).

[13] One scholar, for example, has written that "*Mastrobuono* left open a number of questions, and by its emphasis on contractual assent, begged a most significant one: What happens when parties agree to prohibit or limit arbitral awards of punitive damages?" Stipanowich, *supra* note 3, at 28. Professor Stipanowich went on to state that the Court's *Mastrobuono* opinion, far from resolving the issues swirling about arbitral awards of punitive damages, only catalyzed further debate within the securities industry regarding all of the questions it left unanswered, as well as the new issues to which it gave rise. *See id.*

the *Garrity* decision and its aftermath, as well as the split among the federal circuit courts over the issue of whether the rule articulated in *Garrity* should be followed. Finally, it addresses the Supreme Court's jurisprudence regarding arbitral awards of punitive damages and surveys the unsettled state of the law in the wake of *Mastrobuono*.

A. *Establishing the* Garrity *Rule—The Debate Begins*

1. Garrity v. Lyle Stuart, Inc.

"An arbitrator has no power to award punitive damages, even if agreed upon by the parties. . . . Punitive damages is a sanction reserved to the State, a public policy of such magnitude as to call for judicial intervention to prevent its contravention."[14] This describes the state of New York law just two decades ago regarding awards of punitive damages within the theater of securities arbitration, the result of the New York Court of Appeals' decision in the landmark case of *Garrity v. Lyle Stuart, Inc.*[15] There it was held that because punitive damages are within the exclusive province of governmental authority, they necessarily remain outside the scope of an arbitrator's power to fashion remedies in the out-of-court resolution of disputes.[16] It was not long before securities brokers and dealers seized upon the *Garrity* rule to insulate themselves from exposure to arbitral awards of punitive damages by including New York choice-of-law provisions in their customer agreements.[17] Not surprisingly, many soon

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[14] *Garrity*, 353 N.E.2d at 794.

[15] *See id.*

[16] *See id.*; Carroll E. Neesemann & Maren E. Nelson, *Securities Arbitration Damages*, *in* SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES, at 425, 450 (PLI Corp. Law & Practice Course Handbook Series No. 1062, 1998). The *Garrity* court determined that allowing arbitrators to issue punitive damages would usurp the state as the exclusive and sovereign body holding the power to punish and expressed a fear that allowing private parties to inflict punishments upon one another would harken back to days of old when the rule of law was the law of the jungle and disputes were resolved by fights to the death of the losing party. *See Garrity*, 353 N.E.2d at 796 ("In imposing the penal sanctions in private arrangements, a tradition of the rule of law in organized society is violated. One purpose of the rule of law is to require that the use of coercion be controlled by the State.").

[17] *See* Neesemann & Nelson, *supra* note 16, at 450. As is discussed at greater length below, and as Neesemann and Nelson have noted, the *Garrity* decision is, or at least it was, of great import to the law of securities arbitration. After the New York Court of Appeals engrafted the *Garrity* rule (that is, that arbitrators do not enjoy the

came to view *Garrity* as a catalyst for an evolution in the law of securities arbitration.[18] But this refusal to bar arbitral awards of punitive damages is in itself a recognition of the evolution that the *Garrity* decision signaled. That many commentators and courts have failed to adopt the *Garrity* rule as sound policy reflects both concerns about and recognition of the fact that the *Garrity* court was unwilling to subscribe to the long-held view of arbitration as "a semi-autonomous system of justice largely free from court censorship or oversight, functioning not as part of the judicial process but in lieu of it."[19]

Joan Garrity was the author of two books, published by Lyle Stuart, Inc. Contracts between the author and her publisher included provisions under which the parties were to enter into arbitration in the event of a breach or other dispute.[20] Those provisions, however, neither mentioned the possibility of punitive damages nor granted an arbitrator power to award them.[21] Ultimately, a dispute arose between Garrity and her

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power to issue punitive damages) into the law of the land of New York, a great many securities brokers and dealers set forth New York choice-of-law clauses in their customer agreements. The effects of such provisions was, of course, or at least it was hoped, to incorporate the law of New York—including the *Garrity* rule—into the agreement, thereby effectively precluding the possibility that arbitrators might level punitive damage awards against the brokerage firm or individual broker when disputes with customers or employees entered the arbitral forum. *See id.*

[18] This evolution, however, has met with considerable resistance. After *Garrity* was decided, a number of courts, both federal and state, were reluctant to follow its lead. *See, e.g.*, Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 364 (N.D. Ala. 1984), *aff'd on appeal*, 776 F.2d 269 (11th Cir. 1985). The *Willoughby* court determined that the reasons supplied by the *Garrity* court for refusing to uphold arbitral awards of punitive damages were not of sufficient weight to displace the "principles of arbitral flexibility, judicial deference to an arbitrator's superior knowledge of a given business, and extreme skepticism of judicial intrusion into the disputes parties have agreed to arbitrate." *Id.* State courts have declined to follow the *Garrity* rule as well. *See, e.g.*, Grissom v. Greener & Sumner Constr., Inc., 676 S.W.2d 709 (Tex. Ct. App. 1984) (upholding an arbitral award of punitive damages for breach of contract and a discrete claim involving tortious conduct on a construction project, brought by subcontractors against their general contractor). Similarly, the New York County Lawyers' Association recommended that the state legislature of New York dispense with the *Garrity* rule by statute. *See* Stipanowich, *supra* note 3, at 14 n.79 (citing COMMITTEE ON ARBITRATION AND ADR, NEW YORK COUNTY LAWYER'S ASS'N, PUNITIVE DAMAGES: A PROPOSAL FOR RELIEF 9 (1993)).

[19] Thomas J. Stipanowich, *Punitive Damages in Arbitration:* Garrity v. Lyle Stuart, Inc. *Reconsidered*, 66 B.U. L. REV. 953-59 (1986).

[20] *See Garrity*, 353 N.E.2d at 794.

[21] *See id.*

publisher, and Garrity brought suit for damages in 1971 on grounds of fraudulent inducement, gross underpayment of royalties, and several other "malicious" acts designed to harass her.[22] While that suit was pending, Garrity filed a second suit on grounds of wrongful withholding of $45,000 in royalties.[23] The defendant, Lyle Stuart, Inc. (Lyle Stuart) moved for a stay pending arbitration, which was granted, following which plaintiff demanded arbitration.[24] Garrity requested that the arbitrator grant her $45,000 in withheld royalties, as well as $7,500 in punitive damages, alleging that Lyle Stuart had withheld such royalties with the aim of coercing her into withdrawing the 1971 claim.[25] When, at the arbitration proceedings, the arbitrators rejected Lyle Stuart's objections to the power of the arbitration panel to issue awards of punitive damages, Lyle Stuart's representatives walked out of the proceedings. The arbitrators then awarded Garrity both compensatory and punitive damages.[26]

When Garrity moved to confirm the arbitral award, Lyle Stuart again objected on grounds that the issuance of punitive damages fell beyond the scope of arbitral authority and violated public policy.[27] This time, though, the New York Court of Appeals, per Judge Breitel, agreed, stating, "[s]ince enforcement of an award of punitive damages as a purely private remedy would violate public policy, an arbitrator's award which imposes punitive damages, even though agreed upon by the parties, should be vacated."[28] With that stroke of the judicial pen, Judge Breitel engrafted the *Garrity* rule upon the law of New York, which is to say that awards of

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[22] *See id.*

[23] *See id.*

[24] *See id.*

[25] *See id.*

[26] *See id.*

[27] *See id.*

[28] *Id.* at 795. Judge Breitel's determination that arbitral awards of punitive damages are contrary to public policy was based in no small measure upon the fact that punitive damages are intended to ensure the maintenance of public rights and to deter the actor involved in the instant situation as well as others similarly situated from engaging in the same sort of culpable behavior, rather than to redress private wrongs. "It is a social exemplary 'remedy,'" Judge Breitel wrote, "not a private compensatory remedy." *Id.* Moreover, Judge Breitel argued that the American constitutional system, like all organized societies, is founded upon a rule of law that removes the imposition of coercive penal measures from the purview of private actors. "For centuries the power to punish has been a monopoly of the State, and not that of any private individual. . . . The day is long past since barbaric man achieved redress by private punitive measures." *Id.* at 796–97.

punitive damages were placed beyond the reach of arbitral authority. The ramifications of that decision were soon felt across the length and breadth of the securities industry.[29]

2. *The Effects of the* Garrity *Decision on the Securities Industry*

Garrity, of course, had little to do with the process of securities arbitration. But securities brokerage firms read that decision as a mechanism by which to immunize themselves against arbitral awards of punitive damages, provided that New York law would control any arbitration proceedings in which the securities broker might be engaged.[30] As such, for nearly two decades following the promulgation of the *Garrity* rule, securities firms typically included choice-of-law provisions in their customer agreements specifying New York law as the controlling authority over all disputes.[31] Customer agreements between securities brokers and their customers also tend to include a clause mandating that all controversies be submitted to arbitration under the arbitration rules of one of the Self-Regulatory Organizations (SROs), such as the New York Stock Exchange, Inc. (NYSE) or the NASD, none of which speaks explicitly to the issue of punitive damages.[32] Combined, the effect of these provisions in

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[29] *See* Stipanowich, *supra* note 3, at 4 (noting, for instance, that the NASD, "the body charged with addressing arbitration policies and procedures for the entire securities industry," has joined the debate regarding arbitral awards of punitive damages by proposing a number of reforms (discussed in greater detail in Part V, *infra*) in the wake of the confusion spawned by the *Garrity* and *Mastrobuono* decisions).

[30] *See* John P. Cleary, *Defending Punitive Damage Claims in Securities Arbitration After the NASD Reform, in* SECURITIES ARBITRATION 1997, at 771, 775 (PLI Corp. Law & Practice Course Handbook Series No. 999, 1997). The NASD Arbitration Policy Task Force has recommended that instead of allowing the parties to a securities dispute to select the law that will control its resolution, the law of the state of the investor's residence at the time a claim is filed should control in making the determination as to whether securities arbitrators enjoy the power to issue punitive damages. *See id.*

[31] *See* Bradford D. Kaufman & Anne Tennant Cooney, *Punitive Damages in Securities Arbitration, in* SECURITIES LITIGATION 1996, at 599, 623-24 (PLI Corp. Law & Practice Course Handbook Series No. 958, 1996).

[32] *See id.* at 623. Kaufman and Cooney suggest that the following language is reflective of many of the agreements that were formed between securities firms and their customers during the period immediately following the *Garrity* decision:

> This agreement shall . . . be governed by the laws of the State of New York. . . . Any controversy arising out of or relating to the [customer's] accounts,

customer agreements is to require that all disputes be resolved through arbitration, and then to preclude arbitrators from issuing punitive damages against the securities dealer.[33] Thus, customer agreements of this nature operate to insulate the securities dealers from punitive damages without ever making forthright mention of that fact. By rendering punitive damages unavailable through the mechanism of a New York choice-of-law clause and the incorporation of the *Garrity* rule, securities firms found a channel through which to proscribe the issuance of punitive damages against them without telling customers that they were doing so. The courts, however, did not always prove as willing to enforce these agreements as the securities brokerage firms might have hoped.

B. *The* Garrity *Rule and the Schism Among the Federal Circuits*

Some federal circuit courts were willing to uphold these New York choice-of-law clauses as a ban on arbitral awards of punitive damages, provided that the clauses in issue stood in accordance with the intentions of the parties to the customer agreements.[34] Others construed them as an

> to transactions with [the brokerage firm, its] officers, directors, agents and/or employees . . . shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Board of Directors of the New York Stock Exchange, Inc., as the customer may elect.

Id. at 623 n.133 (citing David J. Effron, *Muddied Waters: Awards of Punitive Damages in Disputes Arbitrated Pursuant to Brokerage Firm Customer Agreements*, 7 DEPAUL BUS. L.J. 333, 334 n.4 (1995) (alteration in original) (quoting Barbier v. Shearson Lehman Hutton, Inc., 948 F.2d 117 (2d Cir. 1991))).

[33] *See* Cleary, *supra* note 30, at 775.

[34] *See* Neesemann & Nelson, *supra* note 16, at 451. Neesemann and Nelson observed that under Supreme Court jurisprudence prior to its decision in *Mastrobuono*, a federal court's view of the effect of a New York choice-of-law clause in a contract was dependent upon a particular court's reading of the specific contract placed before it for interpretation. Therefore, some courts were willing to read a New York choice-of-law clause as a ban on arbitral awards of punitive damages, while others disregarded in wholesale that effect of the decision to make New York law the controlling authority over a securities arbitration agreement. *See id.* Before *Mastrobuono* was decided the majority of the federal circuit courts was willing to uphold arbitral awards of punitive damages despite the inclusion of a New York choice-of-law clause in customer agreements. *See id.* at 452–53. Often, the courts that were willing to uphold arbitral awards of punitive damages justified that decision in part upon grounds that it stood in conformity with the federal policy favoring the arbitrability of claims and the attendant policy of granting arbitrators broad discretion to fashion remedies. *See id.* at 453; *see also* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)

indication of the parties' agreement that New York law would govern the "substantive standards for granting remedies, and not the question of what remedies, including punitive damages, are available in arbitration."[35] The courts falling into the latter category interpreted the inclusion of directives in the customer agreements to pursue arbitration under the various SRO arbitration rules (which appear in almost all customer agreements) as evidence that the parties intended to allow for arbitral awards of punitive damages, because those rules tend to carry expansive remedial provisions.[36]

1. *Federal Circuits Subscribing to the* Garrity *Rule*

The Second and Seventh Circuits determined that the addition of a New York choice-of-law clause to a securities broker's customer agreement precluded the issuance of arbitral awards of punitive damages.[37] In *Barbier v. Shearson Lehman Hutton, Inc.*, the Second Circuit found itself embroiled in the fallout from an arbitral award of punitive damages against the defendant securities brokerage firm after plaintiff customers signed a customer agreement specifying New York law as controlling authority over all disputes.[38] Put simply, the court vacated the arbitrator's award of punitive damages on grounds that the *Garrity* rule prohibited it.[39] The court

(stating that the FAA is a "congressional declaration of a liberal federal policy favoring arbitration agreements").

[35] *Id.*

[36] *See id.* For example, the Eighth Circuit was willing to uphold a punitive damages award despite the inclusion of a Minnesota choice-of-law clause (Minnesota law precluded arbitral awards of punitive damages) in the parties' agreement where the parties had also incorporated the arbitration rules of the AAA into their contract. It reached this result because those rules accord arbitrators the authority "to award any relief that the arbitrator deems just and equitable," which the court interpreted to include punitive damages. *See id.* at 452–53 (citing Lee v. Chica, 983 F.2d 883, 887–88 n.6 (8th Cir. 1993)).

[37] *See* Barbier v. Shearson Lehman Hutton, Inc., 948 F.2d 117, 122 (2d Cir. 1991); Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984).

[38] *See Barbier*, 948 F.2d at 121–22. It hardly needs to be stated that the plaintiff investors contended that the *Garrity* rule conflicted with the FAA, 9 U.S.C. §§ 1–16 (1994), meaning that, in their view, the latter preempted the former, whereas defendant brokerage firm maintained that the New York choice-of-law provision in the customer agreement and the *Garrity* rule inherent therein required the court to vacate the arbitrator's award of punitive damages, *see Barbier*, 948 F.2d at 121.

[39] *See Barbier*, 948 F.2d at 121.

reasoned that the Federal Arbitration Act[40] (FAA) demanded that all private arbitration agreements be enforced according to their terms, and that in this instance, the agreement between the parties was plain.[41] It was to be governed by the laws of New York, including the *Garrity* rule, pursuant to its choice-of-law clause.[42] Thus, the award of punitive damages reached beyond the scope of the arbitrator's authority.[43]

The Seventh Circuit reached the same result in *Pierson v. Dean Witter Reynolds, Inc.*, though for slightly different reasons.[44] Furthermore, the Seventh Circuit was willing to enforce the New York choice-of-law clause and its incorporation of the *Garrity* rule in the arbitration agreement at issue in that case despite one party's superior knowledge of the limitations that it might place on an arbitrator's authority, which is to say, even though one of the parties was unaware that a New York choice-of-law clause would preclude an arbitral award of punitive damages.[45] Not every federal circuit court, however, viewed *Garrity* or its incorporation into securities firms' customer agreements in such a favorable light.

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[40] 9 U.S.C. §§ 1–16.

[41] *See id.*

[42] *See id.* at 121–22.

[43] *See id.* at 122 (stating that "[t]he application of *Garrity* here is not in derogation of the parties' agreement but rather in accordance with that agreement," and that its application was therefore in keeping with the FAA).

[44] *See* Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984). The *Pierson* court held that it would enforce the controverted New York choice-of-law clause even if the plaintiff investors were unaware that their customer agreement with defendant brokerage firm required them to arbitrate all disputes or that it prevented them from being awarded punitive damages in an arbitration proceeding. Plaintiffs' ignorance of the implications of these contractual provisions would not operate to render either the contract or its choice-of-law clause unconscionable:

> Perhaps the Piersons did not realize that punitive damages are not permitted in arbitration under New York law . . . but they were aware that the law of New York was to apply exclusively. . . . The Piersons cannot use their failure to inquire about the ramifications of that clause to avoid the consequences of agreed-to arbitration."

Id.

[45] *See id.*; Cleary, *supra* note 30, at 776 (observing that "[t]he court held that the parties' agreement to a New York choice-of-law provision should be enforced even though one party may not have known that this precluded a punitive damages award").

2. *Federal Circuits Refusing to Uphold the* Garrity *Rule*

Other federal circuits were not so quick to vacate arbitral awards of punitive damages, provided that the parties' agreement established that arbitration of disputes was to proceed according to the arbitration of rules of an SRO or the American Arbitration Association (AAA), but irrespective of whether the agreement contained a New York choice-of-law clause.[46] For example, in *Bonar v. Dean Witter Reynolds, Inc.*,[47] the Eleventh Circuit held that when viewed in the light of the federal policy favoring arbitration created by the FAA, any doubts regarding the arbitrability of a claim should be resolved in favor of arbitration.[48] The court then noted that the customer agreement signed by the Bonars created such a doubt with respect to the arbitrability of a claim for punitive damages. On the one hand, it contained a New York choice-of-law clause, but, on the other, it "incorporat[ed] by reference the rules of the American Arbitration Association, [which] allow[] the arbitrators to 'grant any remedy or relief which [they] deem[ed] just and equitable and within the scope of the agreement of parties.'"[49] Faced with two apparently conflicting provisions with respect to the arbitrability of a punitive damages claim, the court resolved the issue in favor of arbitration. It interpreted the New York choice-of-law clause as a designation of the substantive law to be applied in determining whether punitive damages should be awarded based on the

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[46] *See* Neesemann & Nelson, *supra* note 16, at 452–53.

[47] 835 F.2d 1378 (11th Cir. 1988). *Bonar* stems from a claim for arbitration filed by Mr. and Mrs. Bonar against Dean Witter. After they had opened a securities account with defendant brokerage firm, Dean Witter discovered that the account executive placed in charge of the Bonars' account had embezzled a significant amount of funds from the Bonars' account as well as from those of several other Dean Witter customers. Dean Witter then contacted both the customers whose accounts had been affected by the fraud and governmental authorities. Thereafter, the Bonars filed a claim for arbitration. At the hearing, the defendant brokerage firm conceded liability for compensatory damages. The arbitration panel, however, awarded compensatory damages and punitive damages in the amount of $150,000 against Dean Witter. Dean Witter subsequently learned that an expert testifying on behalf of the Bonars at the arbitration hearing misrepresented his credentials to the arbitration panel. In a bold-faced lie, this expert stated that he had graduated from two universities when in fact he had not. Thus, Dean Witter moved to vacate or modify the award, but the district court denied its motion, and this appeal to the Eleventh Circuit followed. *See id.* at 1379–81.

[48] *See id.* at 1387 (citing Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983)).

[49] *Id.* at 1388 (alterations in original).

conduct of the parties, as distinguished from a determination as to the sorts of remedies, including punitive damages, that could be applied.[50]

The First Circuit reached a similar conclusion on different grounds, though outside the context of securities arbitration. In *Raytheon Co. v. Automated Business Systems, Inc.*,[51] that court interpreted a contract formed between a manufacturer of word processing machines and one of its dealers providing (1) that all disputes arising in connection with the agreement be settled by arbitration, (2) that all such arbitral hearings should proceed according to the rules of the AAA, and (3) that California law would control the interpretation of the agreement.[52] When a dispute arose between the parties, it was submitted to an arbitration panel, which in turn leveled punitive damages against the defendant manufacturer.[53] In reviewing the district court's decision to decline defendant manufacturer's motion to vacate the award of punitive damages, the First Circuit, like the Eleventh Circuit, cited the "strong federal policy in favor of arbitration" as a basis for resolving any doubts with respect to arbitrability of disputes in favor of arbitration.[54] In keeping with that policy, the *Raytheon* court replicated the Supreme Court's statement in dicta that "agreements to arbitrate are to be 'generously construed'"[55] as grounds for holding that the agreement between Raytheon and Automated Business Systems indicated,

> at minimum, an intention to resolve through arbitration any dispute that would otherwise be settled in a court, and to allow the chosen dispute resolvers to award the same varieties and forms of damages or relief as a court would be empowered to award. Since courts are empowered to award punitive damages with respect to certain types of claims, the

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[50] *See id.* at 1387 (stating that the choice-of-law clause, when coupled with the contractual reference to the rules of the AAA, "does not deprive the arbitrators of their authority to award punitive damages").

[51] 882 F.2d 6 (1st Cir. 1989).

[52] *See id.* at 7.

[53] *See id.* at 7-8.

[54] *Id.* at 9 (stating that "[w]hile hortatory statements such as [the one setting forth the "strong federal policy in favor of arbitration"] are helpful in framing our discussion, our conclusion that the arbitrators did not exceed their powers in awarding punitive damages in this case is predicated upon substantially more rigorous analysis" (citing Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983))).

[55] *Id.* at 10 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 626 (1985)).

> Raytheon-Automated arbitrators would be equally empowered.[56]

In the eyes of the *Raytheon* court, the grant of power given the courts by the Constitution is coextensive with the grant of power given arbitrators by the contract that requires disputes to be submitted to them.

In arriving at this result, however, it is important to note that the court essentially ignored the California choice-of-law clause in the parties' agreement, which otherwise would have allowed for the imposition of arbitral awards of punitive damages only in those instances in which the parties' arbitration agreement specifically so provided.[57] In the end, the court's rationale for failing to give effect to the choice-of-law clause simply came down to the federal policy in favor of arbitration, notwithstanding the question of whether this federal policy was encompassed by the intention of the parties as memorialized in their agreement.[58] Presumably, so far as the First Circuit was concerned, arbitrators enjoy the same broad powers to fashion remedies as do juries and the judiciary, notwithstanding the due process questions to which that view gives rise.[59] Whether the Supreme Court would agree with the decision of the First Circuit and its like-minded counterparts, however, was yet to be seen.

C. *The Supreme Court Speaks*

In the midst of this split among the federal circuit courts regarding the issue of whether arbitrators might issue punitive damages, it was at long

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[56] *Id.* Essentially, then, the effect of the *Raytheon* court's holding was to vest in arbitrators the same powers and authorities normally reserved to the judiciary and the public justice system (with all of the apparati intrinsic to it which have been designed and implemented to ensure that defendants not be deprived of property without first having been subjected to the process due them), on the basis of a simplistic theory that "[w]hat is [a]vailable in [c]ourt [s]hould [b]e [a]vailable in [a]rbitration." Cleary, *supra* note 30, at 776.

[57] *See Raytheon*, 882 F.2d at 11; Cleary, *supra* note 30, at 776.

[58] *See Raytheon*, 882 F.2d at 12. Thus, the court stated:

> Where such conduct could give rise to punitive damages if proved to a court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages. Certainly, the fact that the parties agreed to resolve their dispute through an expedited and less formal procedure does not mean that they should be required to surrender a legitimate claim to damages.

Id.

[59] *See infra* Part IV.

last that the Supreme Court finally spoke on the matter. In *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*,[60] the Supreme Court found that the FAA did not require the arbitration of all disputes, but that it did require the courts to enforce private agreements between the parties to settle disputes through arbitration.[61] The arbitration agreement at issue in *Volt* contained a California choice-of-law provision, which operated to prevent the arbitration of a dispute that arose between the parties.[62] Thus, the Supreme Court refused to compel the parties to

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[60] 489 U.S. 468 (1989).

[61] *See id.* at 478. In other words, the Court reiterated its vision of the FAA as a congressional declaration overruling the reluctance, indeed the refusal, exhibited by the judiciary at the time of the passage of the FAA to enforce arbitration agreements. *See id.* (citing Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 219-20 (1985)). In order to accomplish that end, the FAA aimed to ensure that all arbitration agreements formulated between the parties be enforced according to their terms, by placing such agreements on par with any other contract. *See id.* (citing Scherk v. Alberto-Culver Co., 417 U.S. 506, 511 (1974)). Because Congress sought to give effect to private agreements to arbitrate, the *Volt* Court further recognized that the FAA functions to displace state statutes which force parties to settle disputes in a judicial forum when they have agreed to settle their disputes through arbitration. *See id.* at 479 (citing Southland Corp. v. Keating, 465 U.S. 1, 10 (1984)). The Court went on to state that

> it does not follow that the FAA prevents the enforcement of agreements to arbitrate under different rules set forth in the Act itself. Indeed, such a result would be quite inimical to the FAA's primary purpose of ensuring that private agreements to arbitrate are enforced according to their terms. Arbitration under the Act is a matter of consent, not coercion, and the parties are generally free to structure their arbitration agreements as they may see fit.

Id. Therefore, the *Volt* Court seemed to interpret the FAA to mean that the parties to an arbitration agreement were free to structure the terms and conditions of that agreement in any manner they deemed mutually desirable, including the specification of a choice-of-law clause.

[62] *See Volt*, 489 U.S. at 471. *Volt* was centered about a construction contract between Volt and the Board of Trustees of Leland Stanford Junior University under which Volt was to install electrical systems on the campus of Leland Stanford. When a controversy arose between the parties as to compensation for extra work performed, Volt demanded arbitration. In response, Leland Stanford filed suit against Volt and two other construction companies (with whom Leland Stanford did not have an arbitration agreement) working on the project in California state court, alleging fraud and breach of contract. Because the contract between Volt and Leland Stanford contained a California choice-of-law provision, it incorporated a California statute that allowed for a stay of arbitration pending the resolution of related litigation between parties to the arbitration agreement and parties not bound thereby. The effect of that statute, then, was to allow for a stay of arbitration between Volt and Leland Stanford pending the resolution of the

arbitrate their dispute, in keeping with the terms of the arbitration agreements specifying California law as the controlling authority over all disputes but in spite of the federal policy in favor of arbitration codified by the FAA.[63] That is, though the Court recognized that there exists a federal policy in favor of arbitration, that policy could not override the terms of a private arbitration agreement. When a federal policy regarding the exalted status of arbitration conflicted with the terms of the parties' agreement, that federal policy must be subordinated to enforcement of the terms of the contract.[64]

The FAA, in fact, demanded as much. By creating a federal policy in favor of arbitration, the FAA ensured that agreements to arbitrate be treated as any other contract might be treated. Thus, section 2 of the FAA mandates that agreements to arbitrate be enforced according to their terms, and, more pointedly, that those agreements be "valid, irrevocable, and enforceable . . . ."[65] Because "the FAA contains no pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration," the Court found that it would not prevent the application of

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other related cases in which Leland Stanford had filed complaints. *See id.* at 470–71.

[63] *See id.* at 478. The Court described its jurisprudence in this area as having

> recognized that the FAA does not require parties to arbitrate when they have not agreed to do so, . . . nor does it prevent parties who do agree to arbitrate from excluding certain claims from the scope of their arbitration agreement . . . . It simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms.

Id.

[64] *See id.* at 470.

[65] 9 U.S.C. § 2 (1994). That statute provides in full:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, *shall be valid, irrevocable, and enforceable*, save upon such grounds as exist at law or in equity for the revocation of any contract.

Id. (emphasis added). Seen through the lens of the FAA, then, the Supreme Court determined that the parties' agreement to arbitrate according to California law, which in this case translated into a stay of arbitration procedures, must be enforced notwithstanding the policy decision underlying the FAA to encourage the arbitration of all disputes. In brief, the FAA did not prevent the application of a state law preventing arbitral hearings when the parties had, in effect, agreed to be governed by it. *See Volt*, 489 U.S. at 477.

California state law under the parties' choice-of-law clause.[66] The Court interpreted the congressional intention that arbitration agreements be enforced according to their terms to overcome the federal policy favoring arbitration. That remained true here, despite the fact that application of state law resulted in a stay of arbitration rather than a compulsion to submit a dispute to arbitration. Thus, the Court held "that application of [state law] is not pre-empted by the [FAA] in a case where the parties . . . will be governed by [state law]."[67] The federal policy in favor of arbitration was to be displaced by the federal policy in favor of enforcing agreements to arbitrate according to their terms.[68]

After *Volt* was handed down by the Court, the securities industry and the attorneys representing its brokers and dealers invoked its holding with some frequency to secure the enforcement of New York choice-of-law provisions set forth in their customer agreements.[69] However, the *Volt* Court did not go so far as to guarantee that customer agreements containing New York choice-of-law clauses necessarily would be regarded by the lower courts as incorporating the *Garrity* rule. Rather, it merely meant that in some instances arbitral awards of punitive damages could be precluded by a customer agreement between a securities dealer and its customers containing a New York choice-of-law provision.[70] However, whether that conclusion would be reached would be conditioned upon whether a court charged with the interpretation of the agreement would interpret that agreement's New York choice-of-law clause as manifesting the parties' intent to incorporate New York arbitration law, and thus the *Garrity* rule, or simply as a manifestation of the parties' intent to limit the incorporation of New York law to the substantive law of that state, which would not

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[66] *Volt*, 489 U.S. at 477. Though the Court found that the FAA did not pre-empt the application of California law in this case, it did limit that holding to some extent by recognizing that in other situations, state law could be pre-empted if its application would result in a barrier to the complete fulfillment of congressional purposes. *See id.* Here, the congressional purpose behind the FAA was not frustrated, because the purpose of the Act was to ensure that arbitration agreements be enforced according to their terms.

[67] *Id.* at 470.

[68] *See id.*

[69] *See* Cleary, *supra* note 30, at 776.

[70] *See* Neesemann & Nelson, *supra* note 16, at 451 (stating that "under *Volt*, the availability of punitive damages in arbitration has hinged on the courts' interpretation of the parties' arbitration agreements, and particularly on whether a New York choice-of-law provision manifests the parties' intent to incorporate the *Garrity* rule").

include the *Garrity* rule.[71]

Thus, the *Volt* Court left the fundamental question for securities arbitration looming large: does the inclusion of a New York choice-of-law provision in a customer agreement mandating the arbitration of disputes arising thereunder necessarily preclude the issuance of arbitral awards of punitive damages by virtue of its incorporation of the *Garrity* rule? That question was left unanswered, in fact, for six years, until the Court decided *Mastrobuono v. Shearson Lehman Hutton, Inc.*[72] In the interim, that query had to be resolved by whatever lower court was faced with the task of interpreting a customer agreement containing a New York choice-of-law provision, because under *Volt*, the lower courts were being forced to determine whether such a clause manifested the parties' intent to fuse the *Garrity* rule into the terms of their agreement.[73] In *Mastrobuono*, the Court took another step towards an answer to this question.

D. *The Supreme Court Speaks—Again*

1. Mastrobuono v. Shearson Lehman Hutton, Inc.

The *Mastrobuono* Court enforced an arbitral award of punitive damages against a securities dealer despite the New York choice-of-law clause in the customer agreement that it had signed with the plaintiff.[74] That case was spawned by a suit brought in federal district court against the securities brokerage firm of Shearson Lehman Hutton, Inc. by Antonio Mastrobuono and his wife, who alleged that the defendant brokerage firm had mishandled their securities account on the basis of various federal and state law theories.[75] The customer agreement signed by the Mastrobuonos and Shearson Lehman Hutton not only contained a New York choice-of-law provision, but further stated that all disputes were to be submitted to arbitration, which was to proceed under the arbitration rules of the

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[71] *See id.*

[72] 514 U.S. 52 (1995). It should, however, be pointed out that *Mastrobuono* did not determine the threshold question of whether punitive damages are an appropriate award in the arbitration context. *See* Kaufman & Cooney, *supra* note 31, at 624.

[73] *See* Neesemann & Nelson, *supra* note 16, at 455.

[74] *See Mastrobuono*, 514 U.S. at 64 (finding that irrespective of the New York choice-of-law provision in the parties' agreement, "[t]he arbitral award should have been enforced as within the scope of the contract").

[75] *See id.* at 54–55.

NASD.[76] As such, the defendant securities firm filed a motion to compel arbitration, which the district court granted.[77]

The arbitration panel ruled in favor of the Mastrobuonos, awarding both compensatory and punitive damages, the latter award being in the amount of $400,000.[78] Defendant paid the compensatory damages, but moved to vacate the punitive award, and the district court granted its motion.[79] That decision was affirmed by the Seventh Circuit on grounds that the New York choice-of-law clause in the parties' agreement incorporated the *Garrity* rule's ban on arbitral awards of punitive damages.[80] The Mastrobuonos then appealed to the Supreme Court of the United States, which reversed the Seventh Circuit.[81]

The Court framed the issue in *Mastrobuono* as being whether the parties' inclusion of a New York choice-of-law clause incorporated the *Garrity* rule into their agreement.[82] In what initially seemed to be a strong blow to the ability of securities firms to preclude arbitral awards of punitive damages by including a New York choice-of-law clause in their customer agreements, the Court answered that question in the negative.[83] Because the NASD rules of arbitration referenced in the customer agreement provide that arbitrators may award "damages and other relief,"[84] they did not *require* the conclusion that the provisions of the agreement authorized

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[76] *See id.* at 54.

[77] *See id.*

[78] *See id.*

[79] *See id.*

[80] *See id.* at 54–55.

[81] *See id.* The Court stated that it granted certiorari in this case to settle the dispute among the circuit courts of appeals as to the question of "whether a contractual choice-of-law provision may preclude an arbitral award of punitive damages that otherwise would be proper." *Id.* at 55.

[82] *See id.* at 58. *Mastrobuono* seems something of an odd case for the Supreme Court to have reviewed, because ultimately, its decision was nothing more than the product of contractual interpretation. Thus, the case may hold little precedential value, as the next dispute to arise under the terms of a securities firm's customer agreement must be interpreted according to the terms of that particular agreement. *See* Kaufman & Cooney, *supra* note 31, at 626–27 ("In the end, this case came down to the mundane chore of the Supreme Court interpreting the terms of a single, isolated contract. . . . Until the issue is squarely addressed . . . the threshold issue of whether arbitral bodies may constitutionally levy punitive awards will remain a gray area of contention.").

[83] *See Mastrobuono*, 514 U.S. at 63.

[84] *Id.* at 61 (citing NASD CODE OF ARBITRATION PROCEDURE ¶ 3741(e) (National Assoc. of Sec. Dealers, Inc. 1993) (amended 1998)).

punitive damages. But, the Court reasoned, their incorporation into the Mastrobuonos' contract would at least *bear* an interpretation maintaining that punitive awards were contemplated by the parties at the time of contracting.[85] When that determination was coupled with the New York choice-of-law provision, the Court found the customer agreement to be, at best, an ambiguous manifestation of the parties' intentions regarding the authority of the arbitrators to issue punitive damages: "At most, the choice-of-law clause introduces an ambiguity into an arbitration agreement that would otherwise allow punitive damage awards."[86] The Court then cited the federal policy favoring arbitration as grounds for resolving controversies over the arbitrability of disputes in favor of arbitration.[87] Furthermore, the Court turned to the fundamental rule of contract law that ambiguous contract provisions be construed against the drafter to find that Shearson Lehman Hutton "drafted an ambiguous document, and they cannot now claim the benefit of doubt."[88]

Construing Shearson Lehman Hutton's customer agreement against its drafter, then, the Court harmonized the facially discordant choice-of-law and arbitration clauses by finding that the choice-of-law clause "encompass[ed] substantive principles that New York courts would apply, but not to include those special rules limiting the authority of arbitrators. Thus, the choice-of-law provision covers the rights and duties of the parties, while the arbitration clause covers arbitration; neither sentence intrudes upon the other."[89] But because passages such as this one from the

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[85] *See id.* at 61.

[86] *Id.* at 62.

[87] *See id.* (noting that as was discussed in the *Volt* decision, "when a court interprets such provisions in an agreement covered by the FAA, 'due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration'" (quoting Volt Info. Sciences v. Board of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 476 (1989))).

[88] *Id.* at 63. The Court observed that the theory behind the rule calling for ambiguous contracts to be construed against the drafter is "to protect the party who did not choose the language from an unintended or unfair result," and found that rationale to be "well suited to the facts of this case." *Id.* The Court feared that by interpreting the New York choice-of-law provision in the Mastrobuonos' agreement to include the *Garrity* rule, it would be giving effect to a result that the Mastrobuonos may not have considered or even been aware of—that they would be abandoning their right to pursue punitive damages against their securities firm—simply by signing a standard form contract to arbitrate all disputes.

[89] *Id.* at 64. Otherwise the arbitration and choice-of-law provisions would remain irreconcilable, the former allowing for arbitral awards of punitive damages, and the

Court's *Mastrobuono* opinion seem to speak only to the language used in the arbitration agreement at issue in that case, the extent to which *Mastrobuono* resolved the dispute among the federal circuits over arbitrators' authority to issue punitive damages remains elusive.[90]

2. *The Aftermath of* Mastrobuono

Mastrobuono left a host of questions unanswered, and it gave rise to new problems as well. What the *Mastrobuono* Court failed to take into account was the fact that Shearson Lehman Hutton, by virtue of its membership in the NASD, would have been forced to arbitrate any disputes arising between itself and its customers regardless of whether it had signed a customer agreement mandating the same.[91] Therefore, while the *Mastrobuono* decision allows for securities dealers to draft their customer agreements so as to preclude arbitral awards of punitive damages, provided that such provisions are express and written with precision,[92] it is not clear that member firms of the NASD could incorporate such a clause into their contracts with customers without running afoul of the NASD arbitration rules. But those rules, as they were read by the *Mastrobuono* Court, prevent securities firms from drafting contracts that preclude arbitral awards of punitive damages.[93] The effect of such a reading is that securities

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latter forbidding them. This, said the Court, would be an "untenable" interpretation. *Id.*

[90] *See supra* note 82 and accompanying text.

[91] *See* Kaufman & Cooney, *supra* note 31, at 626. Because Shearson Lehman Hutton would have been forced to arbitrate all disputes under the rules of the NASD pursuant to the rules of that SRO even if it had not included such a provision in its customer agreement, it hardly seems dispositive that the brokerage firm drafted the agreement placed before the Court for interpretation. *See id.*

[92] *See id.* at 626–27.

[93] In *Mastrobuono*, the Court read the parties' agreement to arbitrate all disputes pursuant to the NASD rules of arbitral procedures as evidence that the parties may have contemplated awards of punitive damages as falling within the scope of the customer agreement at the time this contract was signed. The Court found that because the NASD's Code of Arbitration Procedure permits arbitrators to award "damages and other relief," the agreement between the Mastrobuonos and Shearson Lehman Hutton was broad enough to accommodate punitive awards by arbitrators. *See Mastrobuono*, 514 U.S. at 60–61. For verification of this conclusion, the Court turned to an arbitration manual produced by the NASD which provides that "[t]he issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy." *Id.* (citing Mastrobuono v. Shearson Lehman Hutton, Inc., 20 F.3d 713, 713 (7th Cir. 1994)); *see also* Neesemann & Nelson, *supra* note 16, at 457. Given this reading of the NASD's Code of Arbitration

firms which are members of the NASD are required to subject themselves to arbitral proceedings to resolve conflicts with customers or employees, and to allow for arbitrators to level punitive damages against them. Those proceedings, however, are not equipped with the due process machinery of the public justice system, despite the fact that this machinery has been mandated by the punitive damages jurisprudence of the Supreme Court and which is designed to prevent the possibility of arbitrary deprivations of property that exist whenever punitive damages are issued.[94]

The conclusion that securities firms subject to the rules of the NASD cannot contract around arbitral awards of punitive damages, even in spite of the fact that the narrow holding in *Mastrobuono* might otherwise allow them to do so,[95] is supported by the NASD's adoption of the "Anti-Goren

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Procedure by no less an authority than the Supreme Court of the United States, it would seem to be impossible for member firms of the NASD, bound by its arbitration rules (as well as, apparently, its manuals for arbitrators), to draft any agreement that would preclude punitive damage awards by arbitrators. *See* Kaufman & Cooney, *supra* note 31, at 651 ("[A]rbitration, as a means of resolving disputes, is practically unavoidable. This is because the rules of the NASD formally mandate the arbitration of all disputes and controversies—regardless of the existence or inexistence of a signed arbitration agreement containing a predispute arbitration clause.").

[94] *See infra* Part IV.

[95] *See* Stipanowich, *supra* note 3, at 28 (observing that "*Mastrobuono* left open a number of questions, and by its emphasis on contractual assent, begged a most significant one: [w]hat happens when the parties agree to prohibit or limit arbitral awards of punitive damages?"); *see also* Robert S. Clemente & Karen Kupersmith, *"Cap"s* [sic] *in Securities Arbitration: A Discussion of Conflicts of Law, Attorneys Fees, Punitive Damages from the Arbitrator's Viewpoint, in* SECURITIES ARBITRATION 1997, at 219, 234 (PLI Corp. Law & Practice Course Handbook Series No. 998, 1997) (stating that the *Mastrobuono* opinion "may have led many parties and attorneys to believe that arbitrators may now award punitive damages in an amount of their choosing whenever they see fit. This, however, is not necessarily the case. Punitive damages remain what they always were—an extraordinary remedy to be used in extraordinary situations."); Kaufman & Cooney, *supra* note 31, at 626–27 ("*Mastrobuono* does suggest that a customer agreement might be drafted to preclude the arbitration of punitive damages. The problem in Shearson's case, apparently, was that their customer agreement was simply too ambiguous with respect to the issue of punitive damages."); Marinuzzi, *supra* note 2, at 72 (noting that "*Mastrobuono* does not unequivocally resolve the dispute"). To be sure, the *Mastrobuono* decision standing in isolation, divorced from the NASD rules and the Court's reading of them, does seem to allow for securities firms to draft customer agreements that will preclude arbitral awards of punitive damages. However, when a securities firm is subjected to the NASD rules, those rules may operate to preclude the firm from presenting the customer with any such agreement. *See* Kaufman & Cooney, *supra* note 31, at 626–27.

rules."[96] The Anti-Goren rules effectually operate to prohibit securities dealers from including language in arbitration agreements that restricts an arbitrator's authority to issue awards of any sort, including, presumably, punitive damages.[97] Thus, though *Mastrobuono*'s holding is apparently narrow enough to allow for securities brokerage firms to preclude arbitral awards of punitive damages with express and clear language in their customer agreements, doing so may expose a member firm of the NASD to sanctions by that body.[98]

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[96] *See* Kaufman & Cooney, *supra* note 31, at 627. The Anti-Goren rules, as they have been labeled, represent the reaction of the NASD and the other SROs to the Sixth Circuit's decision in *Roney & Co. v. Goren*, 875 F.2d 1218 (6th Cir. 1989). There the court held that when an agreement between a securities broker or dealer and its customers specified a specific arbitral forum as the exclusive forum in which disputes might be arbitrated, such provisions would be enforced. *See id.* at 1223. In *Goren*, the customer agreement signed between Roney & Co. (a securities brokerage firm) and Goren specified the NYSE arbitration panel as the exclusive arbitral forum to which disputes would be presented. *See id.* at 1219. In light of that contractual provision, the Sixth Circuit declined to allow Goren to proceed with the claim she filed against Roney & Co. with an NASD arbitration panel. *See id.* The court wrote that "the customer's ability to demand arbitration before the arbitral panel of his choice dictates that he is equally free to agree to limit his recourse to a particular forum." *Id.* at 1223; *see also* Kaufman & Cooney, *supra* note 31, at 627–28 (discussing *Goren*, 875 F.2d at 1223).

[97] *See* Kaufman & Cooney, *supra* note 31, at 627. In the words of the NASD,

> Section 21(f)(4) of the NASD Rules of Fair Practice, as amended, prohibits the use in any customer agreement of any language that (a) limits or contradicts the rules of the NASD or any other self-regulatory organization; (b) *limits the ability of a party to file a claim in arbitration*; or (c) *limits the ability of the arbitrators to make an award* under the arbitration rules of a self-regulatory organization and applicable law.

National Assoc. of Sec. Dealers, Inc., NASD Notice to Members 95-16, *Predispute Arbitration Clauses in Customer Agreements* (1995), *available in* 1995 NASD LEXIS 28, Fedsec Library, Notice File (emphasis added). Given this rule, the effect of the Anti-Goren rules, then, is to preclude securities firms from seeking to preclude arbitrators from issuing "any award," which category would certainly include punitive damages. *See* Kaufman & Cooney, *supra* note 31, at 627.

[98] *See* Kaufman & Cooney, *supra* note 31, at 630. Though securities firms are faced with the dilemma described here, Kaufman and Cooney pose the question of the significance of the fact that *Mastrobuono* was decided six years after the time at which the Anti-Goren rules were encrusted into the NASD Rules of Fair Practice. *See id.* On the other hand, they also cite the fact that the SEC commented on the reach of the Anti-Goren rules as follows: "Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to

3. *The Status of the Law in the Wake of* Mastrobuono

Thus, the current status of the law regarding the authority of securities arbitrators to issue awards of punitive damages can be summarized as follows: "It would now appear that the law, even in New York courts, is to follow *Mastrobuono* and allow punitive damage awards in arbitration, despite a New York choice-of-law clause and even if both parties are New York residents, unless the parties' agreement unequivocally rules them out."[99] But the real question, and the one to which the discussion must now turn, is whether such arbitral awards are proper and fair. A number of commentators have suggested that arbitrators always should be equipped with the authority to issue punitive awards when they see fit (even in the face of an agreement by the parties to an arbitration to allow New York law to control the outcome of disputes) and in keeping with that position, they have further contended that *Mastrobuono* was correctly decided.[100] In part, this may be due to the perception that "while punitive damages are often sought by customers against their brokerage firms . . . they are rarely awarded."[101] Yet the facts belie this assessment.[102] Several state and

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request them, nor arbitrators' rights to award them." *See id.* at 628–29 (quoting Order Approving Proposed Rule Changes Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Release No. 34-26,805, 54 Fed. Reg. 21,144, 21,154 (1989)). With that, the SEC lent the weight of its authority—no mean force—to the Anti-Goren rules.

[99] Neesemann & Nelson, *supra* note 16, at 460. It is suggested that the *Mastrobuono* decision eliminated any barriers to punitive damage awards in an arbitration context in all of the federal circuits and apparently in the state courts as well. *See id.* at 457.

[100] *See, e.g.*, Denise M. Barton, Comment, *The Evolution of Punitive Damage Awards in Securities Arbitration: Has the Use of Punitive Damages Rendered the Arbitration Forum Inequitable?*, 70 TUL. L. REV. 1537, 1561 (1996). Barton argues that in order to ensure that securities violations be curtailed,

> arbitrators need flexible and effective weapons . . . . Given that the perpetrators of these offenses commit the same violations as their predecessors and ingeniously devise new means to circumvent the securities laws and regulations, it is clear that the fines and penalties imposed in the past have not been an effective means of deterrence.

Id.

[101] Stipanowich, *supra* note 3, at 17.

[102] *See* Lansing & Bailey, *supra* note 1, at 206 (recounting the findings of a study commissioned by the SEC that securities arbitrators are prone to issue punitive damages against securities brokers and dealers, while litigants in the court system "received $0

federal courts have allowed for arbitral awards of punitive damages.[103] This trend towards judicial confirmation of arbitral authority to issue punitive damages begs the question of whether they are either desirable or in keeping with constitutional due process requirements.

III. THE ISSUANCE OF PUNITIVE DAMAGES IN THE THEATER OF SECURITIES ARBITRATION CONSTITUTES STATE ACTION

The question of whether awards of punitive damages in the context of securities arbitration are bounded by the limitations set forth in the United States Constitution's due process guarantees ultimately turns upon the answer to the threshold question of whether the issuer of the award is a state actor.[104] Absent state action on the part of the arbitrator, then, the

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of $55,075,000 claimed in punitive/treble damages").

[103] *See* Neesemann & Nelson, *supra* note 16, at 458-62. Neesemann and Nelson note that though the initial reaction of the New York state courts was to disregard *Mastrobuono* and adhere to the *Garrity* rule when presented with customer agreements containing New York choice-of-law clauses, there since have been six New York state cases in which the courts confirmed an arbitral award of punitive damages. *See id.* (citing, inter alia, Americorp Sec., Inc. v. Sager, 656 N.Y.S.2d 762, 764 (N.Y. App. Div. 1997); Kidder, Peabody & Co. v. Fisch, 661 N.Y.S.2d 31, 33 (N.Y. App. Div. 1997); Mulder v. Donaldson, Lufkin & Jenrette, 648 N.Y.S.2d 535, 537–38 (N.Y. App. Div. 1996); and Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Adler, 651 N.Y.S.2d 38, 39 (N.Y. App. Div. 1996)). In addition, all but one of the federal courts seated in New York have allowed for punitive damages to be issued by an arbitrator. *See id.* at 461. Thus, it can no longer be asserted that arbitrators rarely issue punitive awards or that state and federal courts are unwilling to uphold them.

[104] The state action doctrine maintains that the due process constraints set forth in the Fifth and Fourteenth Amendments bind only those private persons whose actions proceed under color of governmental authority to deprive another of his life, liberty, or property. *See* JOHN E. NOWAK & RONALD D. ROTUNDA, CONSTITUTIONAL LAW § 12.1 (5th ed. 1995). In order to determine whether a private person has deprived another of his constitutional rights to due process with state action, a twofold inquiry must be made. First, it must be determined whether "the claimed constitutional deprivation resulted from the exercise of a right or privilege having its source in state authority." Edmonson v. Leesville Concrete Co., Inc., 500 U.S. 614, 620 (1991) (holding that a private party to a court proceeding engaged in state action when he used preemptory challenges to ensure that racial minorities be kept from participation on a jury, and thus that he violated their Fifth and Fourteenth Amendment rights to equal protection under the law). Second, it must be determined "whether the private party charged with the deprivation could be described in all fairness as a state actor." *Id.* Securities arbitrators and their decisions to issue punitive damage awards fall within the rubric of both of these descriptions.

person or firm against whom punitive damages are leveled in a securities arbitration proceeding unquestionably remains vulnerable thereto. Unless state action is present, persons engaged in securities arbitration remain uncloaked in the due process protections of the Fifth and Fourteenth Amendments. Thus, our inquiry necessarily begins with a determination of whether the securities arbitrator can be described "in all fairness" as a state actor.[105]

The Supreme Court has set forth a three-pronged test for evaluating whether a person's actions fall within the rubric of "state action."[106] The first of the three factors to be considered is "the extent to which the actor relies on governmental assistance and benefits . . . ."[107] The second asks "whether the actor is performing a traditional government function . . . ."[108] And the third considers "whether the injury caused is aggravated in a unique way by the inciden[ce] of government authority."[109] As is argued below, when a securities arbitrator makes an award of punitive damages, he qualifies as a state actor because (1) he relies on governmental assistance in issuing the award; (2) he is engaged in what historically has been considered a governmental function; and (3) the deprivation of property that awards of punitive damages necessarily entail is an injury aggravated by the fact of government authority. Put another way, securities arbitrators act as state actors when they make arbitral awards of punitive damages because all three prongs of the *Edmonson* test are satsified.

A. *Governmental Assistance and Benefits*

1. *The NASD's Power to "Self-Regulate" the Securities Industry Stems Solely from the Authority of the Federal Government*

Securities arbitrators engage in state action when they issue awards of punitive damages in part because they rely to a large extent upon

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[105] *Edmonson*, 500 U.S. at 620.

[106] *See id.* Note, however, that each of the three prongs constitutes only a factor to be considered in the state action analysis, rather than a bright-line test for the same. In other words, that one factor is or is not satisfied is not dispositive on the issue of whether state action is present. *See id.*

[107] *Id.* at 621.

[108] *Id.*

[109] *Id.* at 622.

"governmental assistance and benefits" in doing so.[110] It is the authority of federal law that compels securities brokerage firms to submit to punitive damage awards, irrespective of their fairness.[111] Unless securities brokers comply with congressional mandates that require them to become members of SROs, and specifically the NASD, their only option, as the Federal District Court for the Middle District of Florida recognized, is to "choose not to participate in the securities business."[112] NASD rules then compel each member firm to arbitrate any disputes that should arise between itself and customers or employees.[113] Thus, it is essentially federal law that compels the arbitration of securities disputes between brokers and their customers or employees. "The logic is straightforward: (1) the [Securities] Exchange Act mandates that securities firms be members of the NASD, an entity created by Congress, and (2) the [Securities and Exchange Commission], a government regulatory agency, made effective the NASD rule ordering its member firms to arbitrate all of their disputes."[114]

The NASD is a creature of congressional creation, and the United States Code is the fountainhead from which power over its members springs. The Congress enacted laws which make registration in an SRO "registered pursuant to section 78o-3 of [Title 15 of the United States Code]" a prerequisite to trading in securities.[115] However, the NASD is the lone SRO that satisfies this requirement, meaning that if a firm seeks to broker securities, it must first become a member of the NASD.[116] As such,

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[110] *See* Kaufman & Cooney, *supra* note 31, at 653.

[111] *See id.*

[112] Park v. First Union Brokerage Servs., Inc., 926 F. Supp. 1085, 1090 (M.D. Fla. 1996) (holding—erroneously, in the opinion of this writer—that securities firms enter into arbitration procedures strictly of their own volition and therefore, that they are not compelled to arbitrate claims against them by state action).

[113] *See* NASD CODE OF ARBITRATION PROCEDURE Rule 10301(a) (National Assoc. of Sec. Dealers, Inc. 1999).

[114] Kaufman & Cooney, *supra* note 31, at 652.

[115] 15 U.S.C. 78o(b)(8) (1994); *see also* Kaufman & Cooney, *supra* note 31, at 648–49.

[116] *See* Kaufman & Cooney, *supra* note 31, at 648 n.271 (citing Willis H. Riccio, *Disciplinary Proceedings Before the NASD*, R.I. B.J., Oct. 1992, at 21, 21). Though the NASD is the only *association* of brokers and dealers registered pursuant to 15 U.S.C. § 78o, there were ten other SROs registered as exchanges pursuant to 15 U.S.C. § 78f as of 1992. *See id.* Section 78f provides for the registration of securities exchanges with the SEC, and maintains that the Commission "may prescribe . . . the rules of the exchange and such other information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the

securities brokers and brokerage firms have no alternative, (other than to close their doors) to membership in the NASD.

Furthermore, it is not only the creation of the NASD that is a product of federal law; its ongoing authority to regulate its members likewise is effectuated and undergirded by no less an authority than the United States Code.[117] Section 78o-3(b)(2) requires that any securities association registered with the Securities and Exchange Commission (SEC) pursuant to § 78o-3, which is to say the NASD alone, be equipped with the power to force compliance, inter alia, with "the rules of the association."[118] The Second Circuit recognized as much when it described the NASD as "a registered national securities association with congressionally delegated self-regulatory authority," which translates into a "mandate[] to secure compliance by its members with the federal securities laws as well as its own regulations . . . ."[119] Federal law then imparts that power upon the NASD by requiring that its rules contain provisions to "appropriately discipline[]" "its members and persons associated with its members . . . by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction."[120] And it is a federal agency that oversees the rules of the NASD and the other SROs. For this reason, the Supreme Court of the United States recognized that the SEC effectually controls the activities of the NASD as well as the other SROs with unbending authority.[121] Absent this foundation in federal law, the NASD would remain a paper tiger. But the fact remains that Congress has given

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protection of investors." 15 U.S.C. § 78f(a).

[117] *See* Kaufman & Cooney, *supra* note 31, at 650.

[118] 15 U.S.C. § 78o-3(b)(2).

[119] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. National Ass'n of Sec. Dealers, Inc., 616 F.2d 1363, 1365 (2d Cir. 1980). The Third Circuit has offered a similar description of the NASD: 15 U.S.C. § 78o-3(b)(6) "gives the [NASD] the power to discipline its members who fail to conform to the standard of conduct established by the organization. 15 U.S.C. § 78o-3(h) (1976). 'The Act also authorizes the SEC to exercise a significant oversight function over the rules and activities of the registered associations.'" First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 691, 693 (3d Cir. 1979) (quoting United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 700-01 (1975)).

[120] 15 U.S.C. § 78o-3(b)(7).

[121] *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 233-34 (1987) (holding that claims against securities brokers and dealers by their customers under section 10(b) of the 1934 Securities Exchange Act were arbitrable); *see also* Lansing & Bailey, *supra* note 1, at 204.

the NASD and the rules it promulgates sharp teeth, standing at the ready to bring the full weight of the U.S. government down upon the shoulders of any brokerage firm that fails to abide by its rules.

Those rules include a requirement that securities firms arbitrate all disputes.[122] The SEC has approved an NASD rule[123] dictating that

> [a]ny dispute, claim or controversy . . . between a customer and a member and/or associated person arising in connection with the business of such member or in connection with activities of such associated persons *shall* be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon demand of the customer.[124]

Therefore, any broker that refuses to arbitrate disputes with customers will be subject to the wrath of NASD disciplinary measures (including expulsion therefrom), which in turn are imbued with the force of federal law. In the end, the authority of the state, though acting through a private organization, is the force that impels securities firms into the arbitral arena and obligates them to abide by the decisions of the arbitrators, regardless of whether the brokerage firm would have resolved a particular dispute through arbitration.[125]

That the NASD and the arbitration rules it promulgates operate under a banner of federal law, and indeed, wholly as a result of it, is a point that has not been lost on the courts.[126] The Fifth Circuit said the following in regards to the NASD:

> It is the only registered securities association under the Exchange Act . . . . As a registered securities association, it has been "*delegated governmental power in order to enforce, at its own initiative, compliance by members of the industry* with both the legal requirements laid down in

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[122] *See* Kaufman & Cooney, *supra* note 31, at 651 (concluding that although the decision to require "Customer Agreements" with the brokerage firm is "ultimately a policy decision to be made by each securities firm," such firms will, in practice, settle conflicts almost exclusively in arbitral fora since the NASD Code of Arbitration Procedure makes "arbitration, as a means of resolving disputes, practically unavoidable").

[123] *See id.* By approving the NASD rule, of course, the SEC reinforced the federal law already buttressing the NASD's power to regulate and discipline its members.

[124] NASD CODE OF ARBITRATION PROCEDURE Rule 10301(a) (National Ass'n of Sec. Dealers, Inc. 1999) (emphasis added).

[125] *See* Kaufman & Cooney, *supra* note 31, at 651.

[126] *See id.*

the Exchange Act and ethical standards beyond those requirements."[127]

The Federal District Court for the Middle District of Tennessee reached the same conclusion, finding that though the NASD is a private organization, it "arbitrated the dispute and awarded punitive damages against the defendant, and it did so within the framework of federal regulation and approval."[128] Even though the Federal District Court for the Middle District of Tennessee ultimately rejected a theory holding that securities arbitrators engage in state action when they issue punitive awards, the judicial branch nonetheless has made a strong case in support of that proposition.

Likewise, the legislative arm of the federal government seems to concur. The 1975 Senate Report regarding the then-proposed amendments of that year to the Securities Exchange Act of 1934 recognized "that the self-regulatory organizations utilize governmental-type powers in carrying out their responsibilities," and that as a result, "these organizations must be made to conform their activities to the fundamental standards of due process."[129] To be sure, the Senate emphasized in its report that the term "self-regulatory organization" is a misnomer, leading to the fallacious conclusion that it is the securities industry acting of its own accord, rather than in tandem with the federal government, that polices securities dealers and exchanges.[130] "Such a conception of self-regulation," the Senators wrote, "is seriously misleading in that it fails to recognize the essential and continuing role of the federal government."[131] That is to say, the Congress

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[127] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. National Ass'n of Sec. Dealers, Inc., 616 F.2d 1363, 1367 (2d Cir. 1980) (quoting S. REP. No. 94-75, at 23 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 201) (emphasis added).

[128] Glennon v. Dean Witter Reynolds, Inc., No. 3-93-0847, 1994 WL 757709, at *10 (M.D. Tenn. Dec. 15, 1994), *aff'd*, 83 F.3d 132 (6th Cir. 1996).

[129] S. REP. NO. 94-75, at 23. The Senate Report further stated that "[t]he self-regulatory organizations exercise government power . . . ." *Id.* at 201.

[130] *Id.* (stating that any school of thought which adheres to the belief that the securities industry is entirely autonomous and self-regulating, as distinguished from being subject to regulation by the federal government via private organizations, ignores the realities of the interdependence of the NASD and the authority of federal law, as "[i]ndustry regulation and government regulation are not alternatives, but complementary components of the self-regulatory process"); *see also* Kaufman & Cooney, *supra* note 31, at 653.

[131] *See* S. REP. NO. 94-75, at 23. It seems obvious that the cited passages make clear the Senate's view that the NASD is a state actor, taking on its regulatory role as an extension of state authority.

seems to recognize the state action element that inheres in all of the NASD's regulations and disciplinary proceedings.

Perhaps most telling of all is that the SEC adopted the view that the NASD's requirements that members resolve all disputes in an arbitral forum carry "the force of federal law."[132] The NASD went even one step further when it stated that arbitral awards of punitive damages by securities arbitrators are a public function,[133] and therefore constitute state action. In addition, the NASD set forth its assessment of arbitral awards of punitive damages as easily distinguishable from arbitral awards of punitive damages stemming from private agreements to arbitrate disputes on grounds that federal law compels securities brokers to become members of a securities association, while private parties enter agreements to arbitrate strictly of their own volition.[134] The logical extension of this rationale is, of course, that the NASD's requirements constitute state action.[135]

2. *Because the NASD Acts with the Authority of Federal Law, Its Requirement That Member Firms Arbitrate All Disputes Constitutes State Action*

Because the NASD is accorded by federal law the power to force securities dealers to become members therein and then to require, at

[132] Kaufman & Cooney, *supra* note 31, at 655 (citing Brief for the SEC at 1 n.1, Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995) (No. 94-18)). The SEC's amicus brief in *Mastrobuono* cites 15 U.S.C. § 78o-3(b)(6) (1994) as support for the proposition that the "[arbitration rules of the NASD] carr[y] the force of federal law." *Id.* That provision maintains that the NASD must promulgate a series of rules for the governance of its members that will, inter alia, protect investors and the public interest. Because those rules, set forth at the behest of federal law, operate to compel member firms into the arbitral arena, the SEC has rightly concluded that securities dealers enter into arbitration proceedings not because they have been prompted to do so by the "self-regulation" of the NASD, but because they have been prompted to do so by the federal government acting through the NASD. *See id.*

[133] *See* Neesemann & Nelson, *supra* note 16, at 478 n.31.

[134] *See id.* at 478 n.31. The NASD's self assessment as an extension of governmental authority is, in effect, an acknowledgment that "self-regulation" is a misleading term and a clear statement that its authority over securities brokers derives from federal law rather than the intrinsic power of the SRO itself.

[135] *See* Lugar v. Edmondson Oil Co., 457 U.S. 922, 937 (1982) (stating that whenever a person or association "act[s] together with or has obtained significant aid from state officials," that person's or association's actions are fairly attributable to the state).

penalty of expulsion, member firms to arbitrate "any dispute, claim, or controversy . . . between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons,"[136] this compulsion constitutes state action subject to the due process requirements of the Fifth and Fourteenth Amendments.[137] In determining whether state action on the part of a private actor exists, "the inquiry must be whether there is a sufficiently close nexus between the State and the challenged action of the regulated entity so that the action of the latter may be fairly treated as that of the State itself."[138] Arguably, in deciding *Shearson/American Express, Inc. v. McMahon*,[139] the Supreme Court already has found a close nexus between the regulatory activity of the SEC and the arbitral activities of the various SROs, including the NASD.[140] The *McMahon* Court described the authority of the SEC over the arbitration procedures instituted by the SROs as "expansive," stating:

> No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act . . . ; and the Commission has the power, on its own initiative, to abrogate, add to, and delete from any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act . . . . In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.[141]

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[136] NASD CODE OF ARBITRATION PROCEDURE Rule 10301(a) (National Ass'n of Sec. Dealers, Inc. 1999).

[137] *See* Lugar, 457 U.S. at 937 (holding that there exists state action when private conduct is sufficiently bound up with the force of the state, as in those instances, like the actions of the NASD, in which an entity "act[s] together with or has obtained significant aid from state officials").

[138] Jackson v. Metropolitan Edison Co., 419 U.S. 345, 351 (1974) (holding that a utility company was not a state actor for Fourteenth Amendment purposes).

[139] 482 U.S. 220 (1987).

[140] *See* Kaufman & Cooney, *supra* note 31, at 654 (stating that "[i]n 1987, the Supreme Court specifically cited the exceptional governmental involvement in the affairs of SROs as determinative of why SROs should be allowed to arbitrate their disputes").

[141] McMahon, 482 U.S. at 233 (citations omitted) (holding, inter alia, that customers' Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968 (1994 & Supp. II 1996), claims against their securities brokers could be

According to the Supreme Court, the SROs exercise "government-type powers,"[142] which, presumably, is a strong indication that the Court regards the NASD as a state actor.[143]

Moreover, awards of punitive damages in the context of securities arbitration constitute state action because the government compels all securities dealers to become members of the NASD.[144] The import of this observation lies largely in the fact that when the government requires membership in an organization, the Supreme Court has indicated that the organization is bound by the due process guarantees of the Fifth and Fourteenth Amendments with respect to the fees it exacts from and rules it enforces against its members.[145] Extending that logic to the context of securities arbitration, then, because the government compels all securities

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satisfied within the context of the arbitral forum, and that consequently, the clause in the securities brokerage firm's customer agreement mandating the arbitration of all disputes was enforceable with regards to the customer's RICO claims for treble damages).

[142] *McMahon*, 482 U.S. at 235 (citing S. REP. NO. 94-75, at 22 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 201).

[143] *See* Kaufman & Cooney, *supra* note 31, at 654–55.

[144] *See* Peter M. Mundheim, Comment, *The Desirability of Punitive Damages in Securities Arbitration: Challenges Facing the Industry Regulators in the Wake of* Mastrobuono, 144 U. PA. L. REV. 197, 235 (1995). Mundheim contends, and I believe rightly, that arbitral awards of punitive damages by securities arbitrators qualify as state action for two reasons, the first being that which is cited above (i.e., because federal law compels securities dealers to become members of an SRO). *See id.* The other is that such issuance of punitive damages is a "public function," *id.*, discussed at greater length *infra* at Part III.B. Both of these are, of course, valid reasons in support of Mundheim's conclusion, but they are not the exclusive reason that arbitral awards of punitive damages by securities arbitrators are state action. *See* discussion *infra* Parts III.B–III.C.

[145] *See* Mundheim, *supra* note 144, at 235. Mundheim points to the Supreme Court's decision in *Keller v. State Bar*, 496 U.S. 1, 12–16 (1990), for the proposition that "[i]f 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." Mundheim, *supra* note 144, at 235. In *Keller*, the Supreme Court determined that because the State Bar Association of California compelled attorneys practicing in that state to become members of the bar and thus compelled the payment of bar dues thereto, those dues could be used to fund activities connected with the regulation of the practice of law; the Bar Association could not, however, spend compulsory dues to support political or ideological causes or viewpoints without abridging the First Amendment rights of its members. *See Keller*, 496 U.S. at 16. Put another way, because the Bar Association compelled its members to join, it was bound to ensure that its members constitutional rights remain intact. *See id.*

brokers or dealers to become members of the NASD, the NASD's rules and procedures are bound by rigid standards of the Due Process Clauses as set forth by the Supreme Court of the United States.[146] Furthermore, that conclusion is buttressed by the fact that the issuance of punitive damages historically has remained within the exclusive purview of the state.

B. *Punitive Damages Are a Traditional Government Function*

The Supreme Court has described the issuance of punitive damages as, traditionally, a function of the state.[147] In doing so, the Court observed that "'[p]unitive damages have long been a part of traditional state tort law.'"[148] This passage from Supreme Court jurisprudence does not necessarily demand the conclusion that punitive damages are exclusively within the purview of state authority, but it certainly tolerates it. In addition, it serves to establish that punitive damages have been regarded as a function of the state, as distinguished from private actors, even as far back as Blackstone.[149] Furthermore, "[o]ne purpose of the rule of law is to require that the use of coercion be controlled by the State."[150]

In support of this view, it should be recognized that the issuance of punitive damages historically has been considered as remaining within the sole authority of the state precisely because their purpose is, in large part, and as the name suggests, to punish the defendant rather than to recompense the plaintiff for his injuries.[151] Put another way, punishment is a function of governmental authority. If it was not, "vigilante justice" would be sound public policy, or at least there would exist no theoretical justification for limiting it. But, as was noted above, "[f]or centuries the power to punish has been a monopoly of the State, and not that of any private individual . . . . The day is long past since barbaric man achieved redress by private punitive measures."[152]

It was, in fact, for this reason that then-Justice Rehnquist advocated the

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[146] *See infra* Part IV.

[147] *See* Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 15 (1991).

[148] *Id.* (quoting Silkwood v. Kerr-McGee Corp., 464 U.S. 238, 255 (1984)).

[149] *See id.* ("Blackstone appears to have noted their use.").

[150] Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 796 (1976).

[151] *See* Steven R. Salbu, *Developing Rational Punitive Damages Policies: Beyond the Constitution*, 49 FLA. L. REV. 247, 266 (1997) (noting that "one basic function of punitive damages is retribution. The remedy's nomenclature is telling. We label certain damages punitive because they are intended to punish . . .").

[152] *Garrity*, 353 N.E.2d at 796–97 (citations omitted).

proposition that punitive fines should be paid to the state rather than to the plaintiff, who was recompensed in whole through the mechanism of compensatory damages.[153] Rehnquist's position is very much in keeping with the manner in which punishment has been regarded throughout the development of English and American law.[154] All phases of punishment, from its imposition to its execution, have remained a power of the state since the days during which the Magna Carta was drafted, and indeed, since time immemorial.[155] In a more modern context, given that punitive damages are designed to punish the wrongdoer rather than to make the plaintiff whole, "it is anamolous to private recovery of the punishment. The theoretical justification for the punishment suggests that punitive

[153] *See* Smith v. Wade, 461 U.S. 30, 59 (1983) (Rehnquist, J., dissenting).

[154] *See* Kaufman & Cooney, *supra* note 31, at 602-03. For example, after the Normans crossed the English Channel to bring the Saxons (who, prior to that point, enjoyed control over England) to their knees in the Battle of Hastings in 1066, they established a system of law in England in which no clear demarcation was made between civil and criminal law. Monetary punishments for breaches of the law, then, were payable to the state rather than to the aggrieved individual, regardless of the offense. *See id.*

[155] *See id.* at 602-04. Kaufman and Cooney observe that in Norman England, "individuals who had committed a wrong were considered to have offended the crown." *Id.* at 602. Therefore, when punitive fines, then called "amercements," were leveled against the wrongdoer, they were paid to the Crown, which is to say the state. *See id.* at 603. Later, to ensure that the size of the amercement was not excessive, a chapter of the Magna Carta was devoted to the establishment of standards for the application of amercements. *See id.* As a result, the size of the amercement was determined by a court, and subsequently by a group of the wrongdoer's peers, but always under the supervision of governmental authority. *See id.* at 603-04. This historical record provides substantial evidence that since the days to which the American legal system traces it roots, punishment has been viewed as a thing administered by the state rather than the individual. Likewise, Justice O'Connor's assumption that punitive damages are and always were within the sole province of state authority underlies her historical exposition of their development in *Browning-Ferris Industries, Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257 (1989). There she stated that "[t]he link between the gradual disappearance of the amercement and the emergence of punitive damages provides strong historical support for applying the Excessive Fines Clause [of the Eighth Amendment] to awards of punitive damages." *See id.* at 291 (O'Connor, J., concurring in part and dissenting in part). There is evidenced in that passage an assumption that punitive damages are functions of state authority because, were they not issued by state actors, then, of course, there would be no basis for applying the Excessive Fines Clause, or any other clause, of the Constitution. *See* NOWAK & ROTUNDA, *supra* note 104, § 12.1.

damages ought to be paid to the state and not to a private party."[156] The point is simply that if there exists no theoretical justification for allowing private parties to retain the fines spawned by their injuries, nor any historical justification for doing so, there is not nor has there ever been, under the American rule of law, a justification for allowing private parties to exact fines from each other.[157]

For these reasons, the Supreme Court, on more than a single occasion, has characterized the imposition of punitive damages as a species of punishment to be imposed and enforced by state authority.[158] Justice O'Connor nearly equated the criminal punishment function of state authority with the imposition of punitive damages when she wrote, "[t]he character of a sanction imposed as punishment 'is not changed by the mode in which it is inflicted, whether by a civil action or a criminal prosecution.'"[159] The pertinent point here, though, is that if such a penalty "is punishment,"[160] and its character cannot be altered by removing it from one context and placing it in another, then this form of penalty called punitive damages is essentially of the same species as criminal sanctions. Criminal sanctions are "undeniably the province of the State,"[161] thus giving rise to the Supreme Court's definition of punitive damages as "private fines levied by civil juries."[162]

The fundamental rule of contract law, providing that the parties to a contractual agreement are not permitted to determine punishments in the event of a breach, is based on similar foundations. Rather, such punishments are to be determined by the state and not by the aggrieved private individual.

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[156] Calvin R. Massey, *The Excessive Fines Clause and Punitive Damages: Some Lessons from History*, 40 VAND. L. REV. 1233, 1270 (1987).

[157] *See id.* (concluding that even the deterrence argument in favor of punitive damage awards "offers absolutely no justification for the private recovery of these financial punishments, nor does it address the issue of legal limitations upon the size of such punishments").

[158] *See, e.g.*, United States v. Chouteau, 102 U.S. 603, 611 (1880).

[159] *Browning-Ferris*, 492 U.S. at 298 (O'Connor, J., concurring in part and dissenting in part) (quoting *Chouteau*, 102 U.S. at 611).

[160] *Id.* ("[A] civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather can be explained only as also serving either retributive or deterrent purposes, is punishment") (quoting United States v. Halper, 490 U.S. 435, 448 (1989)).

[161] Kaufman & Cooney, *supra* note 31, at 660.

[162] Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974); *see also* Kaufman & Cooney, *supra* note 31, at 659-60.

> [I]n general parties are free to enter into a contract containing whatever terms they wish regarding the establishment of primary rights, but except within narrow limits they are not free to determine what remedial rights will be provided. *Remedies are provided by the state and are defined by public rather than private law.*[163]

And again, the only conclusion available is that punitive damages are and traditionally have been premised on state authority.

In sum, punitive damages have, throughout the legal history of England and the United States, been seated exclusively within the capacity of the state. As such, the leveling of punitive awards satisfies the second of the *Edmonson* factors. Accordingly, those persons or bodies issuing punitive damages should be regarded as state actors.

C. *Aggravation by the Fact of Government Authority*

The third of the *Edmonson* factors for ascertaining state action asks whether "the injury caused is aggravated in a unique way by the inciden[ce] of governmental authority."[164] Almost without question, the issuance of arbitral awards of punitive damages aggravated—and indeed was made possible by—the incidence of governmental authority. Not only are securities dealers forced into arbitral proceedings by the NASD, and thus the authority of federal law,[165] but when arbitral awards of punitive damages are challenged by those against whom they were leveled, it is the state's authority in the form of the public justice system that enforces them.[166] Moreover, judicial confirmation of arbitral awards is expressly provided for in the language of the FAA.[167] It would, presumably, not be possible absent such confirmation from the corridors of state power. And in *Shelly v. Kraemer*, the Supreme Court's awareness of an injury's aggravation by judicial enforcement (i.e., governmental action) prompted it to write that "[s]tate action, as that phrase is understood for the purposes of the Fourteenth Amendment, refers to exertions of state power in all its forms."[168] Therefore, when arbitral awards of punitive damages are issued

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[163] JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 14-31 (3d ed. 1987) (emphasis added).

[164] Edmonson v. Leesville Concrete Co., 500 U.S. 614, 620 (1991).

[165] *See supra* Part III.A.

[166] *See* Kaufman & Cooney, *supra* note 31, at 660.

[167] *See id.*

[168] Shelly v. Kraemer, 334 U.S. 1, 20 (1948) (referring to a type of state power

against securities brokers and dealers, they are "aggravated in a unique way by the inciden[ce] of governmental authority."[169] In many cases, such awards could not have been executed absent state action in the form of judicial enforcement.

Having run arbitral punitive damage awards through the *Edmonson* state action calculus, it cannot be denied that under the test articulated in that decision, arbitrators and arbitral panels that issue punitive damages against one of the parties before them can be described "in all fairness" as state actors. Their authority to do so derives from federal law, the issuance of punitive damages is a traditional government function, and the injury (deprivation of property) is aggravated in a unique way by judicial enforcement of the award. Each of these conclusions satisfies one of the *Edmonson* factors, such that in the aggregate they form the basis for placing arbitral awards of punitive damages within the securities context under the rubric of state action.[170] As state actors, then, securities arbitrators issuing punitive damages are bound by the due process guarantees of the federal Constitution.[171]

IV. PUNITIVE DAMAGES AND THE DUE PROCESS CLAUSES

Due process operates to secure the constitutionality of punitive damage awards. Such procedural protections ensure that persons are not arbitrarily deprived of their property.[172] Thus, the threat of an arbitrary deprivation of property intrinsic to any award of punitive damages[173] mandates that any state actor who issues them against a private party be bound by the Due Process Clause of the Fourteenth Amendment.[174] Because securities arbitrators issuing punitive damages are engaged in state action, they must abide by the procedural protections set forth in the Supreme Court's

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that took the form of judicial enforcement of a restrictive easement against home ownership by African Americans; the Court determined that this was state action writ large and thus a violation of the due process guarantees of the Fourteenth Amendment).

[169] Edmonson, 500 U.S. at 622.

[170] *See id.*

[171] *See generally* NOWAK & ROTUNDA, *supra* note 104, § 12.1(a).

[172] *See* Honda Motor Co. v. Oberg, 512 U.S. 415, 434–35 (1994).

[173] *See id.* at 432 (noting that "[p]unitive damages pose an acute danger of arbitrary deprivation of property").

[174] *See id.* at 434-35. ("A decision to punish a tortfeasor by means of an exaction of exemplary damages is an exercise of state power that must comply with the Due Process Clause of the Fourteenth Amendment.").

jurisprudence treating punitive damage awards.[175] In turn, this gives rise to a survey of the requirements for procedural protections on punitive awards articulated by the Court.

A. *The Foundation*—Pacific Mutual Life Insurance Co. v. Haslip

The Supreme Court has upheld the constitutional validity of those methods of assessing punitive damages that limit the discretion of the jury in determining the size of the award and provide for a series of reviews of the same.[176] Traditionally, punitive damages have been awarded by a jury only after it has been instructed to consider the twofold purpose of punitive damages, retribution and deterrence, and the award is then subjected to reviews at both the trial and appellate levels.[177] The Court observed that jury instructions establishing guidelines for assessment of punitive awards according to the degree of reprehensibility of the defendant's conduct and the necessity for deterrence operate to ensure that jury discretion was "not unlimited" and "confined to deterrence and retribution."[178] The Court reasoned that so long as these constraints upon jury discretion were effectuated, constitutional due process hurdles had been overcome.[179] The Court also made note of the post-trial procedures executed by the trial judge to ensure the fairness of exemplary awards. That the trial judge was required to set forth in the record a detailed exposition of several factors contributing to the justice of awarding punitive damages in the amount assessed by the jury contributed to the award's conformity with the constitutional due process guarantees.[180] Finally, the Court did not leave unnoticed the fact of appellate review of punitive awards as yet another

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[175] *See supra* Part III.

[176] *See* Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 15 (1991) (establishing the Court's long history of approving the common-law method of assessing punitive damage awards).

[177] *See id.*

[178] *Id.* at 19.

[179] *See id.* at 20 ("As long as the [jury's] discretion is exercised within reasonable constraints, due process is satisfied.").

[180] *See id.* The factors considered by the trial judge, and recorded in his opinion, were the egregiousness of the defendant's conduct, the need for deterrence of the defendant's conduct, the impact of the award upon the parties to the action as well as innocent third parties, and other factors. The Court then noted that this test "ensures meaningful and adequate review by the trial court whenever a jury has fixed the punitive damages." *Id.*

check upon both the jury's and the trial court's discretion to award them as well as the amount of the award itself.[181] Thus, in *Haslip* the Court was able to conclude that the guarantees of Due Process Clause had been 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."[182] Absent these procedural protections, however, it is not clear that the Court would have reached the same result.

B. Honda Motor Co. v. Oberg—*Process Matters*

When, however, punitive damages are awarded without an adherence to the procedures for their assessment discussed and endorsed in *Haslip*, the Court has indicated that their issuance falls beyond the bounds of that which is constitutionally permissible. "[A] jury award [of punitive damages] may not be upheld . . . if it was reached in proceedings lacking the basic elements of fundamental fairness."[183] Thus, in *Honda Motor Co. v. Oberg*, the Supreme Court held unconstitutional an amendment to the Oregon Constitution barring judicial review of the size of punitive damage awards unless "the court can affirmatively say there is no evidence to support the verdict."[184] The Court framed the issue in *Oberg* not as whether a punitive award of a particular size would violate the Constitution,[185] but as "the question of what procedures are necessary to ensure that punitive damages are not imposed in an arbitrary manner. More specifically," the Court went on, "the question is whether the Due Process Clause requires judicial review of the amount of punitive damages awards."[186] The manner in which the Court described the issue in this case suggests that the fundamental question underlying the analysis of the

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[181] *See id.* at 20-21 (stating that "appellate review makes certain that the punitive damages are reasonable in their amount and rational in light of their purpose to punish what has occurred and to deter its repetition").

[182] Mundheim, *supra* note 144, at 235.

[183] Browning-Ferris Indus., Inc. v. Kelco Disposal, Inc., 492 U.S. 257, 276 (1989).

[184] Honda Motor Co. v. Oberg, 512 U.S. 415, 418 (1994).

[185] Previously, in *Haslip*, the Court had noted that it "need not, and indeed [it] cannot, draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case." *Haslip*, 499 U.S. at 18.

[186] *Oberg*, 512 U.S. at 420.

constitutionality of punitive damage awards is not whether the size of the award itself comports with the Fourteenth Amendment, but instead whether the procedures employed to arrive at the award comport with the due process guarantees of the Fourteenth Amendment.

Accordingly, the concern of the *Oberg* Court was not with the size of the punitive award the jury leveled against Honda. Instead, it was concerned with the lack of adequate review given it by both the trial and appellate courts under the Oregon Constitution.[187] "What we are concerned with is the possibility that a culpable defendant may be unjustly punished; evidence of culpability warranting some punishment is not a substitute for evidence providing at least a rational basis for the particular deprivation of property imposed by the State to deter future wrongdoing."[188] The manner in which to ensure that there exists a "rational basis for the particular deprivation of property" is through procedural devices by which to administer punitive awards. Specifically, judicial review is the mechanism that guards against arbitrary deprivations of property via the imposition of unlawful punitive damages.[189] But "Oregon has removed that safeguard without providing any substitute procedure . . . ."[190] For that reason, the Court invalidated the Oregon law dispensing with the procedural protections against arbitrary exemplary awards.[191] More generally, the Court stated that it would not hesitate to declare invalid any proceeding from which the adequate procedural safeguards against "arbitrary and inaccurate adjudication" had been excised.[192] Therefore, in view of the Court's opinion in *Oberg*, it would seem that an imposition of punitive damages by a state actor is an unconstitutional deprivation of property absent adequate judicial review of the award or some substitute but equivalent procedure to guard against arbitrary punishments.

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[187] *See id.* (surveying its prior decisions respecting punitive damage awards, the Court reiterated the emphasis that it had placed upon the "availability of both 'meaningful and adequate review by the trial court' and subsequent appellate review" (quoting *Haslip*, 499 U.S. at 20)).

[188] *Id.* at 429.

[189] *See id.* at 432.

[190] *Id.*

[191] *See id.*

[192] *See id.* at 430 (citing, inter alia, Brown v. Mississippi, 297 U.S. 278 (1936)).

C. *Process and Punitives in Securities Arbitration*

With these considerations in mind, it is doubtful that awards of exemplary damages by securities arbitrators could be regarded as consistent with the due process guarantees of the Fifth and Fourteenth Amendments. None of the procedures set forth in *Haslip* or *Oberg*—narrowed jury discretion, judicial review, or appellate review—is available to the parties before an arbitration panel that issues punitive damages. Nor is a substitute procedure available to accord the parties to an arbitration the procedural guarantees of the Constitution. Yet the Supreme Court's decisions in *Oberg* and *Haslip* indicate that without those procedural protections, punitive awards contravene the Fourteenth Amendment.

A number of courts have enumerated grave concerns regarding the constitutionality of arbitral awards of punitive damages, largely for the reasons outlined in *Haslip* and *Oberg*.[193] Formulation of the *Garrity* rule, for instance, was motivated by these concerns:

> [P]unitive damages take their shape from the subjective criteria involved in attitudes toward correction and reform, and courts do not accept readily the delegation of that kind of power. Where punitive damages have been allowed for those torts which are still regarded somewhat as public penal wrongs as well as actionable private wrongs, *they have had rather close judicial supervision*. If the usual rules were followed, there would be no effective supervision over punitive awards in arbitration.[194]

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[193] In addition, a dissenting opinion in the California Supreme Court's decision in *Moore v. Conliffe* highlighted a number of concerns regarding what its author considered to be the procedural shortcomings of arbitral awards in general. Among them were the following: (1) perjury is deterred in judicial proceedings by the fact that they are public proceedings, while arbitral proceedings are purely private; (2) arbitrators may be dependent upon the parties for payment and are not required to take an oath of fairness or impartiality, while a judge and jury are neutral decisionmakers; (3) in arbitration, there is no requirement that witnesses be sworn to tell the truth unless one of the parties requests it; (4) because discovery is reduced, if allowed at all in arbitration, the ability of one of the parties to mount an effective cross-examination against the other is never certain; (5) no record of the arbitral proceeding need be kept, which translates into the fact that the proceeding is not subject to postdecision scrutiny by third parties, thereby insulating witnesses from public exposure should they decide to lie on the stand; and (6) the parties to an arbitral proceeding do not have access to judicial review for insufficiency of credible evidence. *See* Moore v. Conliffe, 871 P.2d 204, 222–23 (Cal. 1994) (Baxter, J., dissenting).

[194] Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 796 (N.Y. 1976) (emphasis

Judge Beam of the Eighth Circuit echoed the same sentiments:

> 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 . . . operate with almost none of the controls and safeguards assumed in *Haslip*.[195]

Moreover, judicial review of punitive awards under the terms of the FAA is likewise so restricted as to have been rendered virtually meaningless.[196] The FAA permits judges to vacate an arbitral award of punitive damages only if (1) the award was the product of "corruption, fraud, or undue means"; (2) the arbitrators evidenced "partiality or corruption" in issuing the award; (3) the arbitrators engaged in "misconduct" in refusing to postpone a hearing or to hear evidence, or for any other "misbehavior" in doing so; and (4) the arbitrators exceeded their powers.[197] The scope of review of arbitral awards is so confined, in fact, that the Second Circuit wrote that it "[had] made it quite clear on earlier occasions that it is the function neither of this [C]ourt nor of the district courts to review the record of arbitration proceedings for errors of law or fact."[198] In a similar vein, the Central District of Illinois wrote in regards to the FAA, "[t]he court's power to vacate an arbitrator's award is severely restricted by [the FAA] and by the strong national policy favoring the resolution of grievances through arbitration where the parties have agreed to be bound by an arbitrator's determination."[199] Most telling of all was this comment from the Seventh Circuit: "[j]udicial review of arbitration awards is tightly limited; perhaps it [should] not be called 'review' at all."[200]

As was indicated above, the absence of meaningful judicial review is not the only procedural (and therefore constitutional) shortcoming of

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added).

[195] Lee v. Chica, 983 F.2d 883, 889 (8th Cir. 1993) (Beam, J., concurring in part and dissenting in part).

[196] *See* Mundheim, *supra* note 144, at 237.

[197] 9 U.S.C. § 10(a)(1)-(4) (1994).

[198] Saxis Steamship Co. v. Multifacs Int'l Traders, Inc., 375 F.2d 577, 582 (2d Cir. 1967).

[199] *In re* Zeigler Coal Co., 484 F. Supp. 445, 446 (C.D. Ill. 1980).

[200] Kaufman & Cooney, *supra* note 31, at 640 (quoting Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 706 (7th Cir. 1994)).

arbitral awards of punitive damages by securities arbitrators. Coupled with the fact that judicial review of arbitral awards is seldom an option for the parties, arbitration is by definition not bound by the rules of evidence, courtroom procedure, or the substantive rules of law.[201] In consequence, arbitrators tend to consider a vast menu of nebulous, imprecise, and largely unknowable factors, all based upon "basic notions of fairness and justice, in making their decisions in the cases placed before them."[202] And because arbitrators are rarely if ever required to set forth the bases for their resolution of conflicts submitted to arbitration,[203] the possibility of error, especially when assessing punitive damages, is not insubstantial. As one commentator put it, "[i]n the proverbial language, you only get one bite at the apple in arbitration, and the result is only as good as your arbitrator."[204] With the possibility of error so great, and the possibility of meaningful judicial review so slim, these considerations would seem to require the conclusion that punitive damage awards by securities arbitrators are neither constitutional nor just.

This view is reinforced by the fact that arbitral awards of punitive damages are an inadequate mechanism to effectuate the deterrence function of punitive damages. In order that punitive damages operate to protect the public by deterring others from engaging in the culpable behavior from which the punitive damages award stemmed, it is necessary that reasons underlying the award be made public. Otherwise, similarly situated persons would be given no guidance as to the appropriate manner in which to tailor their conduct. But arbitral awards, including punitive damage awards, are rarely accompanied by an exposition of the arbitrator's reasons for issuing the award or even the facts giving rise to the dispute.[205] Arbitral awards are in many instances pronounced in a single line of text. The effect, of course, is that arbitral awards of punitive damages are an ineffective and inappropriate means of deterring egregious behavior by securities firms.[206] Thus, suggestions that punitive damages are necessary "to combat the increasing number of securities violations" are anamolous.[207]

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[201] *See* Thomas E. Carbonneau, *Arbitral Justice: The Demise of Due Process in American Law*, 70 TUL. L. REV. 1945, 1958 (1996).

[202] *See* Kaufman & Cooney, *supra* note 31, at 643-44.

[203] *See* Carbonneau, *supra* note 201, at 1958.

[204] *Id.*

[205] *See* Kaufman & Cooney, *supra* note 31, at 630-31.

[206] *See id.*

[207] Barton, *supra* note 100, at 1561.

V. RESPONSES TO DUE PROCESS CONCERNS AND THEIR FAILURE TO SECURE CONSISTENCY BETWEEN SECURITIES ARBITRATION AND THE CONSTITUTION

In response to the due process concerns related to arbitral awards of punitive damages highlighted above, a number of proposals have been made to mitigate them. To take just one example (others will be discussed in greater detail below), the Arbitration Policy Task Force of the NASD has proposed that they be limited to "the lesser of two times compensatory damages or $750,000."[208] Many scholars and investors opposed its approval. A number of commentators have suggested that such a cap on arbitral punitive awards would hamstring arbitrators, removing their ability effectively to sanction misconduct on the part of securities brokerage firms.[209]

The reality of the situation, however, paints a different picture. If the due process guidelines for the imposition of punitive damages set forth by the Supreme Court's *Haslip* and *Oberg* decisions are to serve as a guide, the issue is not the size of a particular award, but rather, the process by which it is assessed.[210] A cap on the size of arbitral awards of punitive damages does nothing to mitigate the due process foibles intrinsic to punitive awards by securities arbitrators, precisely because a punitive award is not constitutionally permissible, irrespective of its size, if due process requirements are not followed.[211]

It is certainly true that "the Constitution imposes a substantive limit on the size of punitive damage awards."[212] But the fact that the size of the award has far fewer and far less important constitutional implications than

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[208] David S. Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, 40 ARIZ. L. REV. 1101, 1107 (1998) (citing ARBITRATION POLICY TASK FORCE, *supra* note 8, at 42).

[209] *See* Stipanowich, *supra* note 3, at 40. Stipanowich criticizes the cap in part on grounds that it was "struck among major players in securities industry arbitration without significant participation of or support from investors and their representatives," *id.* at 40, and because it "will restrict arbitrators . . . and produce a result different than that available in the public courts," *id.* at 44.

[210] *See supra* Part IV.

[211] *See* Honda Motor Co. v. Oberg, 512 U.S. 415, 430 (1994) (stating that if "the absent procedures would have provided protection against arbitrary and inaccurate adjudication, this Court has not hesitated to find the proceedings violative of due process").

[212] *Id.* at 420.

does the process by which it was executed and reviewed is evidenced by the Supreme Court's holding in *TXO Production Corp. v. Alliance Resource Corp.*[213] There the Supreme Court upheld a punitive damage award of ten million dollars, which translated into an amount 526 times the size of the compensatory damage award.[214] In spite of the exorbitant amount, the Court upheld the punitive award because adequate procedures had been followed so as to prevent an arbitrary deprivation of the defendant's property. More specifically, the Court cited as a basis for its ruling (1) that voir dire afforded the parties the opportunity to ensure an impartial jury, (2) the jury assessed the size of the punitive damage award after having listened to adversarial arguments from counsel for both parties, (3) the jury reached its decision as a product of deliberations concerning the evidence presented at trial, (4) the award was reviewed by the trial judge, who affirmed it as standing in conformity with the evidence presented at trial, and (5) the award was subjected to meaningful review by an appellate court which affirmed the award unanimously.[215] The Court observed, "[a]ssuming that fair procedures were followed, a judgment that is [the] product of that process is entitled to a strong presumption of validity."[216]

None of these procedural protections are available in an arbitral forum. Arbitral awards of punitive damages are not subjected to meaningful review at any level,[217] and there is no counterpart to the voir dire in arbitration which would guarantee that the parties are presenting their case to an impartial panel of arbitrators. Thus, because the procedural guidelines articulated by the *TXO Production Corp.*, *Haslip*, and *Oberg* Courts are not followed in the arbitral setting, there can be no presumption of constitutional validity when arbitration panels issue punitive awards.[218]

Procedures designed to ensure that arbitral awards of punitive damages comport with due process, while they might enshrine securities arbitration in a procedural regime that may, arguably, be in keeping with the Fourteenth Amendment, they necessarily impede the goals of, and the incentives to, arbitration. One of the goals of arbitration is a quick and

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[213] 509 U.S. 433 (1993).

[214] *See id.* at 466.

[215] *See id.* at 456–57.

[216] *Id.* at 457.

[217] *See supra* Part IV.C.

[218] *See TXO Prod. Corp.*, 509 U.S. at 457.

efficient resolution of disputes,[219] but to require arbitrators to draft opinions or to subject their decisions to appeal cripples the effectiveness of the operation. It is also assumed that arbitration of disputes between securities brokers and their customers will not result in the sometimes excessive expenses associated with litigation in the public justice system.[220] Again, though, to require parties to appeal decisions of arbitrators would cause arbitration expenses to multiply (especially for those parties who opt to be represented by an attorney in front of the arbitration panel). Furthermore, a series of appeals following every arbitral hearing from which punitive damages flowed would diminish the finality of arbitral hearings that is often cited as one of their benefits.[221]

Though a number of proposals have been tabled for bringing arbitral awards of punitive damages in line with the due process requirements of the Constitution, none will serve adequately both the Constitution's demands and the aims and benefits of the arbitration process. Adherence to requirements of due process necessarily requires expenditures of time and money. Efficiency is not the aim of the due process of the law, and, in fact, remains contrary to its goal of protecting rights through procedural mechanisms.[222] The opposite is true of arbitration.[223] Arbitration's goals of speed and efficiency are therefore inconsistent with a strict adherence to or

[219] *See* Fukaya Trading Co. v. Eastern Marine Corp., 322 F. Supp. 278, 281 (E.D. La. 1971).

[220] *See* Moore v. Conliffe, 871 P.2d 204, 220 (Cal. 1994) (Baxter, J., dissenting). Justice Baxter observes that most courts assume that all disputes subjected to arbitration will be resolved with greater speed, less cost, and increased satisfaction for all the parties involved, none of which could be provided by traditional litigation. But he goes on to call this assumption "insupportable" because it "overlooks the thousands of individuals who, but for arbitration provisions inserted into employment agreements, consumer contracts, bank customer agreements, leases, and other contracts, would resolve their disputes at much less cost and more quickly in small claims court, and in many cases in municipal or superior court." *Id.*

[221] *See* Stipanowich, *supra* note 3, at 1. Professor Stipanowich observes that an "arbitrator's judgment is a formidable impediment to [an] appeal and a spur to getting on with business." *Id.* But if the vanquished party in every securities arbitration proceeding had the option of an appeal, arbitration would cease to function as a "spur to getting on with business."

[222] The Framers of the Constitution feared speed and efficiency in the processes of government. With regards to the legislature, for instance, Alexander Hamilton, writing in The Federalist Papers as Publius, said "promptitude of decision is oftener an evil than a benefit." THE FEDERALIST NO. 70, at 201 (Alexander Hamilton) (Roy P. Fairfield ed., 1961).

[223] *See Fukaya Trading Co.*, 322 F. Supp. at 281.

application of the rigid and sometimes formalistic due process guidelines established by the Supreme Court's Fourteenth Amendment jurisprudence. But because the possibility of an arbitrary deprivation of property is intrinsic to every award of punitive damages, those awards must comport with constitutional guarantees of due process. Arbitral awards of punitive damages in securities arbitration and the Fourteenth Amendment are, therefore, incompatible (at least for the present time). As such, securities arbitrators cannot issue awards of punitive damages with the blessing of the Constitution, rendering the securities arbitration forum an inappropriate context from which to issue exemplary damages.

VI. CONCLUSION

Securities arbitration was once a means of resolving disputes between broker-dealers and their customers and employees in a swift, inexpensive, and generally just manner that still accorded the parties the finality of litigation. But securities arbitrators gave that process an entirely new suit of clothes when they began to issue awards of punitive damages against the people and firms seated across from them at the arbitration table.

Fearing that arbitral awards of exemplary damages might lead to inequitable deprivations of property, the New York Court of Appeals for a time attempted to preclude the practice with its declaration of the *Garrity* rule, premised on the ground that punishment of wrongdoing is seated within the exclusive authority of the state. Some of the federal circuits followed suit, but others went in their own direction. After securities firms seized upon the *Garrity* rule as a means of limiting their exposure to punitive damage awards by arbitrators, the Supreme Court, without establishing the suitability of punitive damage awards to the arbitration context, enforced an arbitral award of punitive damages against a securities dealer that had entered into an agreement containing a New York choice-of-law clause. Thereafter, a flood of scholarly commentary and proposals for the reform of securities arbitration muddled its landscape.

But running through this quagmire is the Due Process Clause of the U.S. Constitution. Because this provision precludes any state actor from arbitrarily depriving another of property without due process of law, they are applicable to securities arbitrators. The actions of securities arbitrators constitute state action to the extent that securities firms are required by federal law to become members of the NASD. The NASD, in turn, which itself acts upon a delegation of authority from the SEC and the Congress, then requires securities dealers to arbitrate all disputes with customers;

hence, securities arbitration constitutes state action and securities arbitrators, state actors. Thus, securities arbitrators must adhere to the exacting procedural standards established by the Supreme Court.

Unwavering conformity with due process guidelines, however, is inconsistent with the goals of arbitration and persons' motivation to enter arbitration. Therefore, until there exists some means of reconciling the two, punitive damage awards remain an unacceptable and constitutionally improper component of the securities arbitration process.