

1993

Punitive Damages in Securites Arbitration: The Interplay of State and Federal Law (or a Smaller Bite of the Big Apple)

Marilyn B. Cane

Follow this and additional works at: <https://scholarship.law.missouri.edu/jdr>



Part of the [Dispute Resolution and Arbitration Commons](#)

Recommended Citation

Marilyn B. Cane, *Punitive Damages in Securites Arbitration: The Interplay of State and Federal Law (or a Smaller Bite of the Big Apple)*, 1993 J. Disp. Resol. (1993)

Available at: <https://scholarship.law.missouri.edu/jdr/vol1993/iss1/7>

This Article is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Journal of Dispute Resolution by an authorized editor of University of Missouri School of Law Scholarship Repository. For more information, please contact bassettcw@missouri.edu.

PUNITIVE DAMAGES IN SECURITIES ARBITRATION: THE INTERPLAY OF STATE AND FEDERAL LAW (OR A SMALLER BITE OF THE BIG APPLE)

Marilyn B. Cane¹

I. INTRODUCTION

As the United States Supreme Court has observed, the Federal Arbitration Act (FAA)² "is something of an anomaly in the field of federal-court jurisdiction. It creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate, yet it does not create any independent federal-question jurisdiction."³ The parameters and effect of state law under the FAA are continually being refined by the courts. Since the FAA is silent regarding the award of punitive damages, the role state law plays with respect to this issue is unsettled.

II. PUNITIVE DAMAGES IN SECURITIES ARBITRATION

The availability of punitive damages is hotly debated by participants in the securities arbitration arena. Many brokerage customers and their counsel contend that punitive damages must be available in arbitration if arbitration is to be a forum equivalent to the courts. On the other side, many brokerage firms and their counsel assert that the purpose of arbitration is to compensate for losses and not to punish errant brokers. They believe that punishment should be the province of courts and administrative bodies. Brokerage firms and investors

1. Professor of Law, Shepard Broad Law School of Nova University; B.A., Cornell University; J.D., Boston College. This Article is based, in part, on Chapter 16 of MARILYN B. CANE & PATRICIA A. SHUB, *SECURITIES ARBITRATION: LAW AND PROCEDURE* 191-204 (1991).

2. 9 U.S.C. §§ 1-15 (1988) [hereinafter FAA].

3. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32 (1982); see also *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 520 (2d Cir.) (quoting *Moses H. Cone*, 460 U.S. at 25 n.32), *cert. denied*, 112 S. Ct. 380 (1991), and *cert. denied*, 112 S. Ct. 1241 (1992).

continue to argue over whether securities arbitrators have the authority to grant punitive damages and whether this is governed by state or federal law.

Traditionally, arbitration panels did not award punitive damages.⁴ Until fairly recently, it was a common sentiment in the courts that

punitive damages are designed to serve the societal functions of punishment and deterrence; unlike contract remedies, they are not designed to vindicate the parties' contractual bargain. Consequently, absent an express provision in the contract, punitive damages should be considered as outside the scope of the parties' agreement and beyond the power of the arbitrator to award.⁵

The leading case cited by courts for denying arbitral punitive damage awards is *Garrity v. Lyle Stuart, Inc.*⁶ *Garrity*, a 1976 New York Court of Appeals case, cited the following three grounds for not allowing punitive damages in arbitration:

1. Freedom of contract does not embrace the freedom to punish, even by contract;⁷
2. Enforcement of punitive damages as a purely private remedy is against public policy;⁸ and
3. To permit arbitral punitive damage awards is to endorse displacing the court and the jury, and therefore the state, as the means for imposing social sanctions.⁹

However, this customary anti-punitive damage stance has been changing in the courts and in administrative bodies. For example, the Securities Exchange Commission (SEC) has stated that brokerage firm customer agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum,

4. See generally Stephen P. Bedell, *Punitive Damages in Arbitration*, 21 J. MARSHALL L. REV. 21 (1987); Thomas J. Stipanowich, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U. L. REV. 953 (1986).

5. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1389 (11th Cir. 1988) (Tjoflat, J., concurring). One publication has stated that punitive damages should not be awarded since they are beyond the scope of commercial arbitration which is a private solution to a business dispute. American Arbitration Ass'n, *Damages in Arbitration*, 2 LAW. ARB. LETTER, Sept. 1978, at 1, 4.

6. 353 N.E.2d 793 (N.Y. 1976); see also *Pierson v. Dean Witter Reynolds, Inc.*, 742 F.2d 334, 338 (7th Cir. 1984); *Appel v. Kidder, Peabody & Co.*, 628 F. Supp. 153, 158 (S.D.N.Y. 1986); *Shahmirzadi v. Smith Barney, Harris Upham & Co.*, 636 F. Supp. 49, 56 (D.D.C. 1985); *O'Driscoll v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,822 (S.D.N.Y. Oct. 26, 1984). See generally Stipanowich, *supra* note 4.

7. *Garrity*, 353 N.E.2d at 797.

8. *Id.* at 795.

9. *Id.* at 796.

including punitive damages.¹⁰ In addition, an emerging common-law trend forcefully challenges the holding in *Garrity*.¹¹ Some courts allow punitive damages only in very narrow circumstances of gross fraud, indicating reckless disregard for the rights of others.¹² Other courts have taken the position that to deny arbitrators all tools available at law will hamstring them and lessen the value and efficiency of arbitration as an alternative dispute resolution forum.¹³ These decisions reflect the view that the federal policy favoring arbitration is best supported by upholding arbitrators' authority to award any appropriate remedy.¹⁴ In several cases, the key determinant of whether to allow punitive damages in arbitration cases is the choice-of-law provision in the customer agreement.

A. *The Continuing Role of State Law: The Volt Decision*

The United States Supreme Court dealt with the effect of a choice-of-law provision in a contract providing for arbitration in *Volt Information Sciences, Inc. v. Board of Trustees*.¹⁵

Volt concerned a construction contract containing an arbitration clause. The contract called for the governing law to be where the project was located, which was in California.¹⁶ When a dispute arose, one party to the agreement made a demand for arbitration, but the other party filed an action in court seeking indemnification from two other parties with which it did not have an arbitration agreement.¹⁷ The trial court stayed the arbitration pursuant to the California Civil Procedure Code, and this decision was upheld on review by the state court of appeals despite the fact that the matter could not have been stayed under the FAA's procedural rules.¹⁸

10. Adoption of Rule Changes to Securities Arbitration Rules, Exchange Act Release No. 26,805, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,414, at 80,113 (May 10, 1989) [hereinafter Exchange Act Release No. 26,805].

11. See, e.g., *Bonar*, 835 F.2d at 1387; *Aldrich v. Thomson McKinnon Secs., Inc.*, 756 F.2d 243, 246 n.3 (2d Cir. 1985); *Willis v. Rubiera-Zim*, 705 F. Supp. 205, 208 (D.N.J. 1988); *Ehrich v. A.G. Edwards & Sons, Inc.*, 675 F. Supp. 559, 564 (D.S.D. 1987); *Duggal Int'l v. Sallmetall*, No. 84 Civ. 7170 (S.D.N.Y. May 8, 1986); *Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc.*, 598 F. Supp. 353, 358, 360-61 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985); *Starkenstein v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 572 F. Supp. 189, 191-92 (M.D. Fla. 1983); *Willis v. Shearson/American Express*, 569 F. Supp. 821, 824 (M.D.N.C. 1983). *But see Appel*, 628 F. Supp. at 158; *Baselski v. Paine, Webber, Jackson & Curtis, Inc.*, 514 F. Supp. 535, 543 (N.D. Ill. 1981).

12. See, e.g., *Bonar*, 835 F.2d at 1387; *Aldrich*, 756 F.2d at 247; *Ehrich*, 675 F. Supp. at 564; *Willoughby Roofing*, 598 F. Supp. at 358, 360-61.

13. See, e.g., *Rubiera-Zim*, 705 F. Supp. at 208; *Willoughby Roofing*, 598 F. Supp. at 361-62 (explaining Alabama law); *Willis v. Shearson/American Express*, 569 F. Supp. at 824.

14. See, e.g., *Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc.*, 776 F.2d 269, 270 (11th Cir. 1985).

15. 489 U.S. 468 (1989).

16. *Id.* at 470.

17. *Id.* at 470-71.

18. *Id.* at 471.

One party argued that the FAA clearly applied to the case, and that, under the Supremacy Clause, the FAA's procedural rules took precedence over those of California.¹⁹ However, the United States Supreme Court affirmed the California Court of Appeals in a split decision, holding that, although the FAA is generally applicable, it does not preempt state procedural rules.²⁰ Justice Rehnquist, writing for the majority, stated that although contracts subject to the FAA should be resolved with "healthy regard for the federal policy favoring arbitration,"²¹ this does not mean there is a "federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply meant to ensure the enforceability, according to the terms, of private agreements to arbitrate."²² Despite the fact that the FAA was enacted in 1925 to overcome the judiciary's long-standing hostility toward arbitration, the key reason for its passage was to ensure that private parties could enforce arbitration agreements in accordance with their initial intent.²³ Thus, according to the majority in *Volt*, parties are free to craft their arbitration agreements as they see fit, including a choice-of-law provision selecting applicable procedural rules.²⁴

The *Volt* case held that when "the parties have agreed to abide by the state rules of arbitration, enforcement according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the [FAA] would otherwise permit it to go forward."²⁵ Since the parties chose California law to govern their agreement, they consented to be governed by California's procedural rules, including the rule which provided for a stay of arbitration pending resolution of related litigation between a party to the arbitration agreement and third parties not so bound.²⁶

The dissent in *Volt* by Justices Brennan and Marshall conceded that parties to an arbitration agreement could write an agreement outside the purview of the FAA altogether.²⁷ In such a case, the parties could permit governance by a state rule, which would otherwise be preempted by the FAA.²⁸ However, according to Justice Brennan, the question of whether the parties' agreement was outside the FAA's coverage was governed by federal and not state law.²⁹ While agreeing with the majority that the federal policy is to ensure enforceability of agreements to arbitrate according to their terms, the dissent disagreed with the majority's conclusion that federal policy was not thwarted by the application of the

19. *Id.* at 474, 476-77.

20. *Id.* at 479.

21. *Id.* at 475.

22. *Id.* at 476. The majority stated that "[t]he FAA contains no express pre-emption, nor does it reflect a congressional intent to occupy the entire field of arbitration." *Id.* at 477.

23. *Id.* at 478.

24. *Id.* at 479.

25. *Id.*

26. *Id.*

27. *Id.* at 485 (Brennan, J., dissenting).

28. *Id.*

29. *Id.*

California rule.³⁰ The dissent stated that if customary choice-of-law clauses were to be construed by state courts as an intent to exclude the application of federal law, "the result would be to render the [FAA] a virtual nullity."³¹ Justice Brennan also noted that since the contract in *Volt* contained an arbitration clause, the parties' intention was presumably to arbitrate.³² Additionally, since the parties included a choice-of-law clause, they selected which state's law (not whether state or federal law) would govern their relationship.³³ According to the dissent, such choice-of-law clauses "simply do not speak to any interaction between state and federal law."³⁴ Moreover, in the dissent's view, since the contract specified "the law of the place," this specification would include federal law:³⁵ "By settled principles of federal supremacy, the law of any place in the United States includes federal law."³⁶

Although it is not clear what effect *Volt* will ultimately have regarding choice-of-law provisions and punitive damages, it may be argued that the anti-punitive-damage stance is substantive and not procedural in nature, and, therefore, *Volt* is not controlling. On the other hand, it may be asserted that the thrust of *Volt* is that the parties are free to choose governing law in the agreement, and the FAA's mandate is to enforce the parties' agreement according to its terms.³⁷ In fact, this second view was embraced by two recent Second Circuit Court of Appeals cases, *Fahnestock & Co. v. Waltman*³⁸ and *Barbier v. Shearson Lehman Hutton Inc.*,³⁹ which have read *Volt* broadly. These cases applied New York's

30. *Id.* at 486-87.

31. *Id.* at 491.

32. *Id.* at 480 n.2.

33. *Id.* at 490-91.

34. *Id.* at 488.

35. *Id.* at 490.

36. *Id.*

37. This is evinced by the majority's statement that not to enforce agreements to arbitrate under a set of procedural rules other than the FAA would be contrary to "the FAA's primary purpose of ensuring that private agreements to arbitrate are enforced according to their terms Just as [parties] may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted." *Id.* at 479.

The Supreme Court has also held that the excessive fines clause of the Eighth Amendment of the United States Constitution does not apply to awards of punitive damages in cases between private parties. See *Browning-Ferris Indus. v. Kelco Disposal, Inc.*, 492 U.S. 257, 260 (1989). Although the case was not an arbitration case and did not involve securities law, it may be significant because the Court held that "[i]n a diversity action, or in any other lawsuit where state law provides the basis of decision, the propriety of an award of punitive damages for the conduct in question, and the factors the jury may consider in determining their amount, are questions of state law." *Id.* at 278. It is possible to read this case with *Volt* and to conclude that state law will have a far larger role in determining the propriety of arbitrators assessing punitive damage awards than previously thought.

38. 935 F.2d 512, *cert. denied*, 112 S.Ct. 1991. See *infra* notes 44-66 and accompanying text for additional discussion of this case.

39. 948 F.2d 117 (2d Cir. 1991). See generally Brian R. Hajicek, Note, *Punitive Damages in New York Arbitration: Who is Really Being Punished?*, 1992 J. DISP. RESOL. 361 (discussing *Barbier*). See *infra* notes 67-96 and accompanying text for additional discussion of this case.

anti-punitive damage stance in New York Stock Exchange (NYSE) securities arbitration cases where New York law governed. However, whether other circuits and the Supreme Court will follow the lead of the Second Circuit remains unclear.

B. New York's Anti-Punitive Damages Stance

New York law on the issue of punitive damages, as outlined by the *Garrity* rules on preclusion, is particularly significant in securities arbitration since many brokerage firms' customer agreements provide that New York law governs.⁴⁰ In fact, although the trend for some major brokerage firms is to permit customers to choose non-industry-sponsored arbitral forums (e.g., the American Arbitration Association (AAA)) as contrasted with industry-sponsored forums referred to as self-regulatory organization (SRO) forums (e.g., the National Association of Securities Dealers, Inc. (NASD) or the New York Stock Exchange (NYSE)), many firms have been intractable with respect to keeping a New York-governing-law clause in customer agreements.⁴¹ The reason is obvious — a number of New York cases have upheld *Garrity's* prohibition on the award of punitive damages in arbitration where New York law was found to apply.⁴²

Fahnestock and *Barbier*, two significant cases decided by the Second Circuit in 1991, applied New York law in denying arbitrators the authority to award punitive damages in securities arbitration. Both cases cited *Volt* for the

40. On the other hand, some New York state and federal courts have modified or turned against the *Garrity* preclusion. In *Aldrich v. Thompson McKinnon Securities, Inc.*, 756 F.2d 243 (2d Cir. 1985), the Second Circuit held that punitive damages could be assessed in certain circumstances. There has to be clear and convincing evidence that the brokerage firm acted in a reckless and wanton fashion in its indifference to tortious conduct of the registered representative, and proof that such conduct was known to the brokerage firm's management. *Id.* at 247.

In *Duggal International, Inc. v. Sallmetall*, No. 84 Civ. 7170 (S.D.N.Y. May 8, 1986), a New York court reasoned that the FAA, rather than state law, applies to the question of whether arbitrators can assess punitive damages since the FAA creates federal substantive law applicable in both state and federal courts. The *Duggal* court held that, because it places substantive limits on arbitrability, *Garrity* should not be followed and ruled that the sanction of punitive damages in arbitration would be prohibited only if there exists (1) a federal policy prohibiting an arbitrator's award of punitive damages or (2) an express or implied contractual limitation on the arbitrator's power to make such an award. *Duggal Int'l*, slip op. at 2-4. Therefore, the power of awarding punitive damages is within an arbitrator's authority. *Id.* at 6.

41. Failure to introduce the New York governing law provision in contract in the arbitration proceeding, and failure to object to evidence on the punitive damage issue, may be deemed a waiver of the right to object to the arbitral award of punitive damages. See *Dean Witter Reynolds Inc. v. Bork*, No. 91-0392, 1991 WL 164465, at *3-4 (E.D. Pa. Aug. 21, 1991).

42. See, e.g., *Shahmirzadi*, 636 F. Supp. at 56; *O'Driscoll*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,134; *Baselski*, 514 F. Supp. at 543; *Shaw v. Kuhnel & Assocs., Inc.*, 698 P.2d 880, 882 (N.M. 1985). For example, in *O'Driscoll*, the court deferred to *Garrity* and ruled that "[s]ince arbitrators are not empowered under New York law to award punitive damages, defendants' motion to strike plaintiffs' claim for punitive damages as to its arbitrable common law claims is therefore dismissed as moot." *O'Driscoll*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,134.

proposition that an arbitration agreement must be given effect according to its terms: If the parties chose New York law, arbitrators could not award punitive damages.⁴³

1. *Fahnestock & Co. v. Waltman*

In *Fahnestock*, a brokerage firm, *Fahnestock & Co.*, indicated on an industry reporting form that a discharged employee, *Waltman*, was under "internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct."⁴⁴ *Waltman*, the employee, alleged that this constituted defamation and filed an arbitration claim with the NYSE against the firm.⁴⁵ There was no governing choice-of-law clause to be construed in *Fahnestock*; the choice of New York governing law was a result of the diversity of citizenship between the parties rather than any explicit agreement between them.⁴⁶

The firm in *Fahnestock* initially commenced the NYSE arbitration because it alleged that *Waltman* refused to return some files after *Waltman* was terminated from employment.⁴⁷ Although the firm initially indicated on the reporting form (the Form U-5) that *Waltman* was not under internal review for fraud or unlawful taking of property, it later amended the form to signify that *Waltman* was under such review.⁴⁸ *Waltman* filed an answer denying the allegations that he wrongfully took *Fahnestock's* property.⁴⁹ He also filed a counterclaim "in which he alleged that *Fahnestock* and three of its officers, the chairman of the board, the

43. See *Barbier*, 948 F.2d at 122; *Fahnestock*, 935 F.2d at 517. As the *Fahnestock* decision noted, "[t]he FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." *Fahnestock*, 935 F.2d at 517 (quoting *Volt*, 489 U.S. at 477). Accordingly, state law may be applied in arbitration matters, subject to preemption only "to the extent that it actually conflicts with federal law." *Id.* In *Barbier*, the court stated:

We need not look to the *Fahnestock* rationale to determine whether *Garrity* should be applied here, because the language of the parties' Agreement is clear: "This agreement shall . . . be governed by the laws of the State of New York." The FAA requires that private agreements to arbitrate be enforced in accordance with their terms. As we noted in *Fahnestock*, the "parties are generally free to structure their arbitration agreements as they see fit." Here, the parties elected to abide by "the laws of the State of New York" in the event of a dispute under the Agreement.

Barbier, 948 F.2d at 122 (citations omitted).

44. *Fahnestock*, 935 F.2d at 514.

45. *Id.* There is a securities industry practice of requiring industry personnel to be bound by the constitutions and rules of the self-regulatory organizations of which the employing brokerage firm was a member. These rules require, *inter alia*, that employment controversies between individual brokers and their employing firms must be arbitrated. See generally *CANE & SHUB, supra* note 1, at 232-45.

46. *Fahnestock*, 935 F.2d at 517.

47. *Id.* at 514.

48. *Id.*

49. *Id.*

president, and the general counsel, defamed him by filing the amended Form U-5.⁵⁰

The NYSE arbitration panel awarded Waltman \$56,000 in compensatory damages for wrongful discharge, \$100,000 for defamation, and \$14,700 in legal fees.⁵¹ In addition, the panel awarded \$100,000 in punitive damages although the parties' arbitration agreement was silent with respect to the arbitrators' authority to award such relief.⁵²

Waltman subsequently filed a petition in the Eastern District of Pennsylvania to confirm the arbitral award under NYSE Arbitration Rule 628(a).⁵³ Fahnstock claimed that the arbitrators exceeded their authority by granting an award for defamation and by awarding punitive damages,⁵⁴ and he filed a petition in the Southern District of New York to vacate the arbitral award under Section 10(d) of the FAA.⁵⁵ The Pennsylvania district court stayed the petition to confirm the arbitral award pending the outcome of the action in New York to vacate it.⁵⁶ Shortly thereafter, the New York district court denied Fahnstock's petition to vacate the compensatory damages portion of the arbitral award for defamation but granted its petition to vacate the award of punitive damages.⁵⁷ The New York court found that the arbitrators did not exceed their powers in rendering the compensatory defamation award but held that the arbitrators were prohibited from awarding punitive damages, following the holding in *Garrity*.⁵⁸ Although Fahnstock contended that federal substantive law governs arbitrations conducted pursuant to the FAA, the court held that "the state substantive law as set forth in *Garrity* regarding the inability of arbitrators to award punitive damages, is not in direct conflict with any express provision of the Federal Arbitration Act," and therefore, the court held, its application of *Garrity* would not violate the Supremacy Clause of the United States Constitution.⁵⁹

Fahnstock appealed the New York district court judgment confirming the compensatory damages portion of an arbitration award in favor of Waltman to the Second Circuit.⁶⁰ Waltman cross-appealed from the same judgment insofar as it vacated the punitive damages portion of the arbitration award.⁶¹ The Second Circuit affirmed the district court's decision in full.⁶²

50. *Id.*

51. *Id.*

52. *Id.* at 514, 518.

53. *Id.* at 515.

54. *Id.* Federal jurisdiction was based on the diversity of the parties, as Fahnstock's principal place of business was New York and Waltman resided in Pennsylvania. . *Id.*

55. *Id.*; see 9 U.S.C. § 10(d).

56. *Fahnstock*, 935 F.2d at 515.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.* at 513.

61. *Id.*

62. *Id.* at 514.

The Second Circuit acknowledged that "there is precedent for Waltman's position that federal law and policy confers upon FAA arbitrators the right to award punitive damages even where, as is not the case here, the arbitration parties agree that New York law is to govern."⁶³ The appellate court also agreed that state law regarding the arbitral award of punitive damages in the absence of an arbitration agreement on the subject was not preempted by federal substantive law.⁶⁴ After finding that jurisdiction was predicated on diversity of citizenship and the agreement was silent regarding the issue of punitive damages, the court held that "the propriety of an award of punitive damages for the conduct in question . . . [is a] question[] of state law."⁶⁵ Thus, the *Fahnestock* court applied the *Garrity* rule prohibiting the award of punitive damages by arbitration.⁶⁶

2. *Barbier v. Shearson Lehman Hutton, Inc.*

In *Barbier*, the New York federal district court held that arbitration panels could award punitive damages and confirmed a NYSE arbitration award which included \$25,000 in punitive damages.⁶⁷ In their complaint, the Barbiers alleged claims of conversion, breach of fiduciary duty, breach of contract, negligence and/or recklessness, and assault against the broker, Bendelac, and his former employer, Shearson Lehman Hutton, Inc. (Shearson).⁶⁸ The Barbiers contended that because their account was non-discretionary, Shearson could not trade for the account without their express authorization.⁶⁹ They further asserted that Bendelac and Shearson forged several documents providing Shearson discretionary authority to trade in commodities and commodities options.⁷⁰ The Barbiers ultimately demanded an arbitral award for compensatory, consequential, and punitive damages.⁷¹ Bendelac and Shearson denied the allegations and maintained that no Shearson employee had forged the Barbiers' signature on any documents.⁷²

After several days of hearings, the NYSE arbitration panel filed its unanimous award in favor of the Barbiers.⁷³ The arbitrators awarded them

63. *Id.* at 516 (citing *Bonar*, 835 F.2d at 1386-88; *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151 (S.D.N.Y. 1990); *Singer v. E.F. Hutton & Co.*, 699 F. Supp. 276 (S.D. Fla. 1988); *Duggal Int'l*, No. 84 Civ. 7170). The *Barbier* district court decision which was cited by the *Fahnestock* court was later reversed by the Second Circuit. See *Barbier*, 948 F.2d 117.

64. *Fahnestock*, 935 F.2d at 518.

65. *Id.* (quoting *Browning-Ferris Indus.*, 492 U.S. at 278).

66. *Id.*

67. 752 F. Supp. 151 (S.D.N.Y. 1990), *rev'd* 948 F.2d 117 (2d Cir. 1991).

68. *Id.* at 154.

69. *Id.* at 153.

70. *Id.*

71. *Id.* at 154.

72. *Id.*

73. *Id.*

\$155,645, of which \$25,000 represented punitive damages.⁷⁴ Bendelac filed a motion to vacate the award in its entirety, arguing that the panel exceeded its powers or that the panel imperfectly executed its powers by: (1) failing to render an award on all of the submitted issues; (2) basing its award on a claim that had been withdrawn; and (3) awarding punitive damages.⁷⁵ Shearson challenged only that portion of the award granting punitive damages.⁷⁶ However, the district court granted the Barbiers' petition to confirm the arbitral award and denied Bendelac's and Shearson's motions to vacate the award.⁷⁷

According to the lower court in *Barbier*, the threshold issue was whether federal or New York arbitration law controlled the arbitration agreement.⁷⁸ Although Shearson argued that the inclusion of a New York choice-of-law clause in the customer agreement mandated that New York law controlled, the court disagreed and found that since the underlying transactions were of an interstate nature, the FAA clearly applied to the arbitration provision at issue.⁷⁹ The court stated that it is "well-settled in this circuit that federal arbitration law applies to contracts embraced by the Act despite [the inclusion of] a contractual New York choice-of-law provision."⁸⁰

The New York federal district court noted, however, that the application of federal law had been "undercut" by the United States Supreme Court's decision in *Volt*.⁸¹ Nonetheless, the district court concluded that *Volt* did *not* stand for the proposition that any time a choice-of-law provision is included in an arbitration agreement, such a provision necessarily requires the application of state rather than federal arbitration law.⁸² According to the *Barbier* district

74. *Id.* Of the total sum, the panel apportioned \$31,129 to Shearson and \$124,516 to Bendelac. *Id.*

75. *Id.*

76. *Id.*

77. *Id.* at 164.

78. *See id.* at 154. The Agreement, in paragraph 13, contained an arbitration provision which stated, in pertinent part:

This agreement shall . . . be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [the Barbiers'] accounts, to transactions with [Shearson, its] officers, directors, agents and/or employees for [the Barbiers] or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. as [the Barbiers] may elect. . . . Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.

Id. at 153.

79. *Id.* at 155.

80. *Id.* (citations omitted). Other circuits have held likewise. *See, e.g.,* *New England Energy, Inc. v. Keystone Shipping Co.*, 855 F.2d 1, 4 n.2 (1st Cir. 1988), *cert. denied*, 489 U.S. 1077 (1989); *Mesa Operating Ltd. Partnership v. Louisiana Intrastate Gas Corp.*, 797 F.2d 238, 243-44 (5th Cir. 1986); *see also Apex Fountain Sales, Inc. v. Kleinfeld*, 818 F.2d 1089 (3d Cir. 1987).

81. *Barbier*, 752 F. Supp. at 155.

82. *Id.* at 156 (emphasis added).

court, *Volt* stood for the proposition that the parties' intention should govern and should be carried out by a court enforcing the arbitration agreement.⁸³

In *Barbier*, the district court found the language of the agreement at issue to be ambiguous and, after interpreting the same, concluded that, unlike the situation in *Volt*, the parties did not agree that arbitration proceedings under their agreement were to be governed by state arbitration law.⁸⁴ Accordingly, it held that federal substantive law governed and empowered the arbitration panel to award punitive damages.⁸⁵

Bendelac appealed the district court decision to the Second Circuit, contending that the district court erred by denying his motion to vacate the arbitral award in its entirety.⁸⁶ As grounds for vacatur, Bendelac asserted that the arbitration award was based partly on issues that were withdrawn from arbitral consideration and that the arbitration panel failed to consider all issues presented to it.⁸⁷ He also argued that the court incorrectly applied Section 10(d) of the FAA, rather than New York's arbitration statute.⁸⁸ Bendelac alleged that the FAA did not apply because jurisdiction was predicated on diversity of citizenship, where the *Erie* doctrine required the court to apply New York's arbitration statute.⁸⁹ He further argued that because the court was required to apply settled New York law which prohibited the arbitrators from awarding punitive damages under *Garrity*, it was error to confirm the panel's punitive damage award.⁹⁰

The Second Circuit affirmed the district court's judgment confirming the compensatory damages arbitral award and reversed the portion of the judgment confirming the arbitral award of punitive damages.⁹¹ The appellate court applied *Garrity* to preclude the award of punitive damages.⁹² However, the court reversed the award of punitive damages based not upon the *Erie* doctrine but because *Volt* required the court to enforce the parties' agreement according to its terms and the agreement affirmatively chose New York law to govern.⁹³

83. *Id.* at 155-56 (footnote omitted).

84. *See id.* at 156. "The clause admits of two possible readings, neither of which is patently unreasonable: the choice-of-law clause might on the one hand be read to require only the application by the arbitrators of New York *substantive* law to disputes between the parties, or on the other to mandate that New York substantive law, as well as New York arbitration law, apply to the arbitration proceeding." *Id.* (emphasis in original).

85. *Id.* at 157. The *Barbier* court also noted that application of the *Garrity* rule in that although the parties had agreed to arbitrate claims, including punitive damage claims, a state-made rule declaring punitive damages non-arbitrable would result in these claims going to court rather than arbitration. *See id.* at 160 & n.15. This would result in a paradox that would both frustrate the intent of the parties and thwart the mandate of the FAA. *See id.* n.15.

86. *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 118 (2d Cir. 1991).

87. *Id.*

88. *Id.*; see N.Y. CIV. PRAC. L. & R. 7501-7511 (McKinney 1980 & Supp. 1991).

89. *Barbier*, 948 F.2d at 118.

90. *Id.*

91. *Id.*

92. *Id.* at 121.

93. *Id.* at 122.

The Second Circuit stated that it did not need to look to the *Fahnestock* rationale to determine whether *Garrity* applied because the language of the parties' agreement in *Barbier* clearly stated: "This agreement shall . . . be governed by the laws of the State of New York."⁹⁴ The appellate court stated that the FAA requires private arbitration agreements to be enforced in accordance with their terms⁹⁵ and remarked that:

"Where . . . the parties have agreed to abide by [New York law], enforcing [that law] according to the terms of the agreement is fully consistent with the goals of the FAA," even if the result is that punitive damages are prohibited where in the absence of the choice-of-law provision, they would be permitted.⁹⁶

3. *American Arbitration Association (AAA) v. NYSE Provisions Regarding Punitive Damages: Court Interpretation*

In *Fahnestock*, the Second Circuit left open the possibility that arbitrators could award punitive damages even where New York law applies, provided "that an agreement between the parties specifically [authorized the arbitrators] to award punitive damages."⁹⁷ As the court noted:

The *Garrity* rule, to the extent that it purports to prevent arbitrators from awarding punitive damages in the face of such an agreement, seems to invoke preemption concerns, since it runs afoul of the federal substantive law rules that sweep aside any state attempt to interfere with the agreement of the parties. The matter may be left for another day, however, because we deal here only with the NYSE provisions for arbitration.⁹⁸

94. *Id.*

95. *Id.* (citing *Volt*, 489 U.S. at 478-79).

96. *Id.* (quoting *Volt*, 489 U.S. at 479) (alterations in original).

97. *Fahnestock*, 935 F.2d at 518.

98. *Id.* The court noted that:

Article XI of the NYSE Constitution provides that "[a]ny controversy between . . . a member, allied member or member organization and any other person, arising out of the business of such member . . . shall at the instance of any such party, be submitted for arbitration . . ." 2 N.Y.S.E. Guide (CCH) ¶ 1501. . . . NYSE rule 600(a) provides for the arbitration of "[a]ny dispute, claim or controversy," 2 N.Y.S.E. Guide (CCH) ¶ 2600, and NYSE rule 347 provides for the arbitration of "any controversy . . . arising out of the employment or termination of employment . . .," 2 N.Y.S.E. Guide (CCH) ¶ 2347. Despite this broad language, the NYSE provisions are silent with regard to the power of arbitrators to award punitive damages.

Id. at 518-19.

The NYSE rules, at issue in both *Barbier* and *Fahnestock*, are silent as to punitive damages; indeed the NYSE rules have no provisions relating to remedy or relief.⁹⁹ From this silence the Second Circuit concluded that "[c]learly, if the NYSE wanted to empower arbitrators to award punitive damages, it could have done so."¹⁰⁰ The court noted that, contrary to the NYSE rules, the AAA rules provide that arbitrators may award "any remedy or relief which [is] just and equitable and within the scope of the agreement" which may have led to a different result had the AAA been the arbitral forum.¹⁰¹

In addition, although the NYSE award form, used by NYSE arbitrators to memorialize the arbitral awards, allows for entry of a punitive damages award under a specific heading marked "punitive damages," the *Fahnestock* court was not persuaded that this meant that the NYSE arbitrators had the authority to award punitive damages in the case under review because the award forms were not part of the arbitration agreement.¹⁰² It then stated "[m]oreover, NYSE arbitrations occur throughout the nation, and our holding here does not mean that in those states in which arbitral punitive damages awards are permitted, arbitrators may not appropriately utilize the punitive damages section of the award form."¹⁰³

A recent Ninth Circuit case, *Todd Shipyards Corp. v. Cunard Line, Ltd.*,¹⁰⁴ concerned, *inter alia*, punitive damages in an AAA maritime arbitration involving a contract governed by New York law.¹⁰⁵ The arbitration panel awarded \$1 million to Todd Shipyards "as a consequence of Cunard's bad faith, deceptive practices, knowingly making incorrect representations to Todd Shipyards during contract performance and improper withholding of monies due."¹⁰⁶ Cunard asserted that the district court erred in confirming that part of the award because it was beyond the power of the arbitrators to make a punitive damage award since under New York law (as expressed by *Garrity*), commercial arbitrators do not have the authority to award punitive damages.¹⁰⁷ Cunard relied on *Volt*, but the Ninth Circuit was not persuaded and stated:

Cunard argues that *Volt* dictates the view that when a state choice of law provision is part of a contract, state arbitration rules should be followed, and, because New York law prohibits punitive damage awards in arbitrations, the award in this case should be vacated. Cunard's reliance on *Volt* is inapposite. The Supreme Court did not say a state choice of law provision that does not expressly encompass

99. *Id.* at 519.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. 943 F.2d 1056 (9th Cir. 1991).

105. *Id.* at 1058.

106. *Id.* at 1063.

107. *Id.* at 1062.

state arbitration rules, does so by operation of law. The Court merely said that it would not disturb a state court's factual determination that the parties to the contract in *Volt* intended to invoke California arbitration rules.¹⁰⁸

The *Todd Shipyards* case involved the application of the AAA Commercial Arbitration Rules, and the Ninth Circuit upheld the punitive damage award. The *Todd Shipyards* court noted, however, that "New York substantive law applies to the question whether, although the panel had the power to award punitive damages, the award was legally appropriate given the facts of this case Under New York law, punitive damages for fraud are available 'upon a showing of willful and wanton conduct.'"¹⁰⁹

The *Todd Shipyards* court distinguished the result in *Fahnestock* because *Fahnestock* was decided under the rules of the NYSE and because the *Fahnestock* court acknowledged that cases under the AAA rules might provide for the arbitral award of punitive damages because of the AAA's expansive remedies rule.¹¹⁰

The Commercial Rules of the AAA include Rule 43, which reads as follows: "Scope of Award: The arbitrator may grant any remedy or relief which the Arbitrator deems just and equitable within the scope of the agreement of the parties."¹¹¹ The Securities Arbitration Rules (SAR) of the AAA include Rule 43: "The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract."¹¹² Thus, whether the AAA's Commercial Arbitration Rules or the SAR Rules are chosen, the arbitrators are seemingly vested with ample powers to design suitable remedies.

It is not certain, however, that even the AAA's liberal remedies provisions will convince every court that arbitral punitive damages are permissible. In Judge Tjoflat's special concurrence in *Bonar v. Dean Witter Reynolds, Inc.*,¹¹³ he noted that, although in the appropriate case the award of punitive damages may be "just and equitable," such award could not be deemed to have been "within the scope of the parties'" agreement absent some express agreement.¹¹⁴ According to Judge Tjoflat:

Punitive damages are designed to serve the societal functions of punishment and deterrence; unlike contract remedies, they are not designed to vindicate the parties' contractual bargain. Consequently,

108. *Id.* (citing *Volt*, 489 U.S. at 477).

109. *Id.* at 1063 (quoting *Faller Group, Inc. v. Jaffe*, 564 F. Supp. 1177, 1185 (S.D.N.Y. 1983)).

110. *Id.* n.6.

111. *Id.*

112. *Id.*

113. 835 F.2d 1378.

114. *Id.* at 1388 (Tjoflat, J., concurring).

absent an express provision in the contract, punitive damages should be considered as outside the scope of the parties' agreement and beyond the power of the arbitrator to award.¹¹⁵

A 1989 First Circuit case, *Raytheon Co. v. Automated Business Systems, Inc.*,¹¹⁶ held that punitive damages were available in AAA commercial arbitration.¹¹⁷ The court distinguished labor arbitration, where punitive damages are not generally available, from commercial arbitration.¹¹⁸ Whereas the award of punitive damages in labor arbitration might undermine the ongoing relationship of unions and management, such continuing relationship is not generally present in commercial arbitration.¹¹⁹ As the court noted, commercial arbitration is a one-shot endeavor and not a means of ongoing dispute resolution.¹²⁰ Therefore, a punitive damage award is appropriate in commercial arbitration since

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. Parties that do wish arbitration provisions to exclude punitive damages claims are free to draft agreements that do so explicitly.¹²¹

The *Raytheon* rationale is also applicable to securities arbitration. Securities arbitration is a one-shot endeavor designed to address a specific grievance; the parties almost never maintain a relationship after a dispute. In addition, the impetus for permitting punitive damage awards is even greater in customer-broker securities arbitration than in commercial arbitration, as the relative bargaining position of the parties, compared with that of two business entities, is usually disproportionate. However, the suggestion in *Raytheon* that the parties to an arbitration agreement may exclude punitive damages should not be available in the SRO broker-customer context.¹²² Indeed, the SEC Release approving the rules changes in SRO arbitration states:

[a]greements 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

115. *Id.* at 1388-89.

116. 882 F.2d 6 (1st Cir. 1989); see also Douglas R. Davis, Note, *Overextension of Arbitral Authority: Punitive Damages and Issues of Arbitrability* — *Raytheon Co. v. Automated Business Systems, Inc.*, 65 WASH. L. REV. 695 (1990) (recommending that arbitrators interpret broadly-drafted arbitration clauses to encompass only traditional contract remedies).

117. *Raytheon*, 882 F.2d at 12.

118. See *id.* at 11.

119. *Id.*

120. *Id.*

121. *Id.*

122. See *id.*

agreement cannot limit the parties' rights to request them, nor arbitrators' right to award them.¹²³

4. *Bonar v. Dean Witter Reynolds, Inc.*

In 1988, the Eleventh Circuit Court of Appeals decided *Bonar v. Dean Witter Reynolds, Inc.*¹²⁴ and addressed the effect of a New York choice-of-law provision in a brokerage firm's customer agreement, affirming that punitive damages may be awarded by AAA arbitrators.¹²⁵ The court held that a choice-of-law provision in a contract under the FAA only designates the substantive law the arbitrators must apply to determine whether the conduct of the parties warrants an award of punitive damages; it does not affect whether the arbitrators can award punitive damages if the rules of the arbitration forum permit such awards.¹²⁶ In *Bonar*, the court stated that *Garrity* had no application to cases arising under the FAA because

Garrity dealt only with the powers of arbitrators under state law and state public policy, and has no application in cases arising under the [FAA]. . . . Thus, a choice of law provision in a contract governed by the [FAA] merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages¹²⁷

Since *Bonar* preceded *Volt*, the possible impact of *Volt* on *Bonar* has not been squarely addressed by the courts. However, in *Fahnestock*, the Second

123. Exchange Act Release No. 26,805, *supra* note 10, at 80,113.

124. 835 F.2d 1378.

125. *Id.* at 1388.

126. *Id.* at 1387. The effect of choice-of-law provisions in a contract providing for arbitration was at issue in *Volt*, 489 U.S. 468. *Volt*, a contractual dispute, did not involve securities arbitration, though it involved interstate commerce, and the parties provided that California law was to apply. *Id.* at 470. The pertinent California statute, *see* CAL. CIV. PROC. CODE § 1281.2(c) (West 1978), permits a stay of arbitration pending the resolution of related litigation with third parties not bound to arbitrate, whereas the FAA would require the arbitration to go forward. *See Volt*, 489 U.S. at 472. The Supreme Court held that the FAA, although applicable, did not preempt state procedural rules. *Id.* at 478. As the Court stated:

There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate. Interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration — rules which are manifestly designed to encourage resort to the arbitral process — simply does not offend the rule of liberal construction set forth in *Moses Cone*, nor does it offend any other policy embodied in the FAA.

Id. at 476. The *Volt* decision has been criticized by Robert Coulson, President of the AAA. *See AAA President Says Volt Decision Creates a Setback for Arbitration*, 3 *Alternative Disp. Resol. Rep.* (BNA) 135 (April 13, 1989).

127. *Bonar*, 835 F.2d at 1386-87.

Circuit noted that *Bonar* involved an arbitration under that AAA rules and that the AAA rules, unlike the NYSE rules, potentially allowed punitive damage awards.¹²⁸ This may portend the resumption of the long-fought battle of the arbitration forums. For if *Fahnestock* and *Barbier* are limited to mean that the *Garrity* prohibition applies to the NYSE, but not the AAA, arbitrations' customers will fight to have the AAA as their forum.¹²⁹

C. Punitive Damages Should Be Available in Securities Arbitration

Given the results in *Fahnestock* and *Barbier*, it is unlikely that brokerage firms will allow customers to choose governing law other than New York. Since the touchstone of *Volt* is to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms, it follows that courts must scrutinize the parties' intent. Judge Mahoney, dissenting from the holding on punitive damages in the Second Circuit majority opinion in *Fahnestock*, criticized the lower court in that case because "no significant inquiry was conducted regarding the intent of the parties, and no mention was made of the NYSE award form, applicable here, that makes specific provision for punitive damages. Rather, *Garrity* was deemed controlling as a matter of law."¹³⁰ As Judge Mahoney thoughtfully noted,

[t]he majority's approach effectively disregards the existence of a "body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate," and imposes the diversity regime of *Erie R.R. v. Tompkins*. The *Erie* standard is intended, however, for "all matters except those in which some federal law is controlling." It therefore seems to me clearly inappropriate to apply *Erie*-generated rules to an area for which, the Supreme Court has instructed, federal law supplies the rule of decision. That, however, is precisely what the majority has done in this case.¹³¹

Judge Mahoney cited numerous cases permitting arbitrators to award punitive damages by looking to the agreement of the parties,¹³² and, in particular, cited cases similar to *Bonar*, wherein punitive damages were allowed even when the

128. *Fahnestock*, 935 F.2d at 519.

129. See CANE & SHUB, *supra* note 1, at 48-54 (discussing the "AMEX Window").

130. *Fahnestock*, 935 F.2d at 520 (Mahoney, J., dissenting).

131. *Id.* (quoting *Moses H. Cone*, 460 U.S. at 25 n.32) (citation omitted).

132. *Id.* at 521 (citing *Raytheon*, 882 F.2d at 9-12; *Bonar*, 835 F.2d at 1386-88; *Pyle v. Securities U.S.A., Inc.*, 758 F. Supp. 638, 639 (D. Colo. 1991); *Barbier*, 752 F. Supp. at 159-60; *Peabody v. Rotan Mosle, Inc.*, 677 F. Supp. 1135, 1139 (M.D. Fla. 1987); *Ehrich*, 675 F. Supp. at 563; *Duggal Int'l*, No. 84 Civ. 7170; *Willoughby Roofing*, 598 F. Supp. at 357-59; *Willis v. Shearson/American Express*, 569 F. Supp. at 823).

pertinent contract explicitly stated that it was to be governed by New York law, notwithstanding *Garrity*.¹³³

The United States Supreme Court, in *Shearson/American Express v. McMahon*,¹³⁴ also buttressed arbitration panels' authority to make punitive damage awards. *Shearson* has by implication endorsed substituting arbitration panels as the mechanism for imposing sanctions since "it would be hard to imagine that if the Supreme Court empowers an arbitration panel to award treble damages in RICO cases it would preclude punitive damages in appropriate cases."¹³⁵ Moreover, in *Perry v. Thomas*,¹³⁶ decided one week after *McMahon*, the Court ruled that Section 2 of the FAA created a body of federal substantive law of arbitrability that would govern and be enforceable in state and federal courts even if there was state substantive or procedural policy to the contrary.¹³⁷ This seemingly meant that state court cases precluding punitive damage awards would be preempted by the FAA's broad grant of powers to arbitration panels.

The thrust of the United States Supreme Court cases in the securities arbitration area, particularly *Shearson/American Express v. McMahon*¹³⁸ and *Rodriguez de Quijas v. Shearson/American Express*,¹³⁹ is that the policy of the securities laws is not undermined by permitting arbitration of securities disputes. Judicial hostility toward arbitration has been abated in large part because the Court has found arbitration to be an acceptable forum to protect the rights created under the securities laws and common law. In *Rodriguez de Quijas*, the Court stated that, to the extent older cases "rested on suspicion of arbitration as a method of weakening the protection afforded in substantive law to would-be complainants, it has fallen out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes."¹⁴⁰ To conclude that a person has the right to punitive damages in a court setting, but not in an arbitral setting, would undermine the concept that arbitration is an appropriate alternative forum.

The Securities and Exchange Commission's (SEC) position is that arbitration agreements between brokerage firms and customers may not be used to curtail the

133. *Id.* (citing *Raytheon*, 882 F.2d at 11; *Bonar*, 835 F.2d at 1386-87; *Barbier*, 752 F. Supp. at 153, 160 & n.15; *Singer*, 699 F. Supp. at 278-79; *Ehrich*, 675 F. Supp. at 565; *Duggal Int'l*, No. 84 Civ. 7170; *Willoughby Roofing*, 598 F. Supp. at 359; *Willis v. Shearson/American Express*, 569 F. Supp. at 823-24).

134. 482 U.S. 220 (1987).

135. DAVID E. ROBBINS, *SECURITIES ARBITRATION* 125 (1988). A New York state court has held that New York's public policy prohibiting an arbitrator from awarding punitive damages does not preempt the federal rule that RICO treble damage claims are arbitrable. See *Helmsley Enters. v. Lepercq, Deneufize & Co.*, 562 N.Y.S.2d 113, 115 (App. Div. 1990).

136. 482 U.S. 483 (1987).

137. *Id.* at 489-91.

138. 482 U.S. 220.

139. 490 U.S. 477 (1989).

140. *Id.* at 481.

availability of punitive damages.¹⁴¹ This position should not be undermined indirectly through a choice-of-law provision any more than through a direct prohibition in the agreement. Ironically, in cases governed by New York law, punitive damages have been precluded under the NYSE rules despite the fact that the SEC has oversight jurisdiction over the NYSE, a self-regulatory organization, but punitive damages have not been precluded under the rules of the AAA, an independent organization.

It is implausible that brokerage customers realize that by signing a customer agreement with a New York governing choice-of-law clause they may have abandoned any claim they may have to punitive damages. Moreover, it is preposterous to assume that the typical investor will understand the nuances of choosing the AAA or NYSE forums with respect to the punitive damage issue. I can only echo what Judge Mahoney stated in his dissent in *Fahnestock* that "the imposition of the *Garrity* rule, without respect to [or any meaningful inquiry regarding] the contractual intention of the parties, directly contravenes the dominant purpose and policy of the FAA as repeatedly articulated by the Supreme Court."¹⁴²

At the behest of the SEC, the SROs now require brokerage agreements with arbitration clauses to include highlighted language informing customers that they are "waiving their right to seek remedies in court."¹⁴³ However, the SEC, through its SRO rule-making oversight, does not presently require brokerage-firm agreements with customers to explain that this could mean that customers signing such agreements may be relinquishing their rights to obtain punitive damages in arbitration. In such cases, customers' consent to arbitration may not be truly informed.

Regardless of the forum selected, punitive damages should be available only where there has been particularly egregious conduct, as New York courts have held. In 1989, the New York Court of Appeals specified that punitive damages were not recoverable unless "the wrong complained of is morally culpable, or is actuated by evil and reprehensible motives."¹⁴⁴ Additionally, the United States District Court for the Southern District of New York has dismissed punitive damage claims in securities fraud cases that fall short of the New York standard.¹⁴⁵

Apart from whether *Garrity* prohibits arbitrators from assessing punitive damages, there is the issue of whether garden variety securities law fraud claims would support a claim for punitive damages in court. Some courts refuse to permit arbitrators to award punitive damages specifically in cases where the cause

141. See Exchange Act Release No. 26,805, *supra* note 10, at 80,113.

142. *Fahnestock*, 935 F.2d at 521 (Mahoney, J., dissenting).

143. See Exchange Act Release No. 26,805, *supra* note 10, at 80,113.

144. *Franks v. Cavanaugh*, 711 F. Supp. 1186, 1192 (S.D.N.Y. 1989) (citing *Walker v. Sheldon*, 179 N.E.2d 497, 498 (N.Y. 1961)); see also *Borkowski v. Borkowski*, 355 N.E.2d 287 (N.Y. 1976) (*per curiam*)).

145. *Franks*, 711 F. Supp. at 1192 (citing *Zaretsky v. E.F. Hutton & Co.*, 509 F. Supp. 68, 77 (S.D.N.Y. 1981)).

of action arises under express liability provisions of the federal securities acts¹⁴⁶ or where the cause of action is implied from those provisions. Courts denying punitive damages under the federal securities acts generally do so as a matter of statutory construction and federal policy, both of which involve an analysis of congressional intent. Section 28(a) of the Securities and Exchange Act of 1934 (the 1934 Act), which limits recovery in private actions to "actual damages," withholds punitive damages from claimants alleging a violation of express or implied provisions.¹⁴⁷

In *Green v. Wolf Corp.*,¹⁴⁸ the Second Circuit rejected the contention that punitive damages were available for an implied cause of action under Rule 10b-5 of the 1934 Act.¹⁴⁹ Similarly, in *Globus v. Law Research Service, Inc.*,¹⁵⁰ the same court prohibited punitive damage awards under a cause of action implied from section 17 of the Securities Act of 1933.¹⁵¹ In *Tinaway v. Merrill Lynch & Co.*,¹⁵² the court dismissed claims for punitive damages in an arbitration setting because the underlying causes of action under the federal securities law did not support punitive awards in a litigation setting.¹⁵³

This limitation may be more apparent than real, however. The United States Supreme Court has not directly faced the question of whether the federal policy denying punitive damages awards under the federal securities laws would apply to pendent state claims joined in an arbitral forum. Although *Globus* reserved the question of whether section 28(a) of the 1934 Act prohibits punitive damages in a pendent common law fraud claim joined to an action based on the 1934 Act, the Second Circuit held that punitive damages were recoverable in common law fraud claims.¹⁵⁴ Moreover, the numerous cases upholding punitive damage awards in securities arbitration demonstrate that claimants may successfully allege pendent state law and common law claims which do not prohibit the imposition of punitive damages along with allegations of violations of the federal securities laws. However, even assuming that punitive damages were allowable and awarded, there are further unresolved issues. For example, Florida statute section 768.73¹⁵⁵ provides that "[i]n any civil action" 60 percent of punitive damages

146. See generally Thomas J. Kenny, *Punitive Damages in Securities Arbitration: The Unresolved Question Of Pendent State Claims*, 37 CATH. U. L. REV. 1113 (Summer 1988).

147. See generally *id.*

148. 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

149. *Id.* at 303; see also *Flaks v. Kogel*, 504 F.2d 702, 706-07 (2d Cir. 1974).

150. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

151. *Id.* at 1283-85; see also *In re Energy Sys. Equip. Leasing Sec. Litig.*, 642 F. Supp. 718, 744 (E.D.N.Y. 1986) (deciding that punitive damages were not available under either the 1933 or 1934 Acts).

152. 692 F. Supp. 220 (S.D.N.Y. 1988).

153. *Id.* at 226; see also *Stacy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 88 C 9163, 1989 WL 20777 (N.D. Ill. 1989).

154. *Flaks*, 504 F.2d at 707.

155. FLA. STAT. CH. 768.73 (1992).

awarded are payable to the state.¹⁵⁶ In *Miele v. Prudential Bache Securities, Inc.*,¹⁵⁷ the Eleventh Circuit has recently certified to the Florida Supreme Court the question of whether the statute applies to punitive damages awarded in arbitration.¹⁵⁸ Obviously, this has great practical import where Florida law is deemed to apply.

III. CONCLUSION

The reluctance of the brokerage industry to allow lay arbitrators to award punitive damages, particularly given the limited right of appeal from arbitral awards, is understandable. However, if New York choice-of-law provisions become standard and non-negotiable, the industry may be faced with oft-threatened Congressional action to limit SRO arbitration in the broker-customer context or court cases invalidating such clauses. Section 2 of the FAA provides that a written provision to arbitrate is enforceable, "save upon such grounds as exist in law or in equity for the revocation of any contract."¹⁵⁹ The Supreme Court has stated that, "courts should remain attuned to well supported claims that the agreement resulted from . . . overwhelming economic power that would provide the grounds 'for the revocation of any contract.'"¹⁶⁰ Indeed, the Supreme Court left open the possibility of challenging customer agreements on the basis that the contract was adhesive in nature.¹⁶¹ To date, contractual defenses to the enforcement of arbitration clauses in customer agreements, including allegations that such clauses should not be enforced because they are contracts of adhesion or are unconscionable, have met with extremely limited success.¹⁶² However, the door is not absolutely closed to such arguments. The securities industry may win the battle, but lose the war.

By attempting to limit arbitrators' authority to award punitive damages where they may be appropriate, through choice-of-law and choice-of-forum provisions in standard contracts, the industry undercuts the fundamental fairness of securities arbitration. Securities arbitration must not only be objectively fair, but it must be perceived by the investing public as an effective alternative to judicial resolution. To be truly an alternative, all available remedies should be available in securities arbitration, including punitive damages.

156. *Id.*

157. 986 F.2d 459 (11th Cir. 1993).

158. *Id.* at 460.

159. 9 U.S.C. § 2.

160. *Mitsubishi Motors v. Soler Chrysler Plymouth, Inc.*, 473 U.S. 614, 627 (1985) (quoting 9 U.S.C. § 2).

161. *Rodriguez de Quijas*, 490 U.S. at 484.

162. See *CANE & SHUB*, *supra* note 1, at 268-76.

