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Punitive Damages in Securities Arbitration: The Unresolved Question of Pendent State Claims

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PUNITIVE DAMAGES IN SECURITIES ARBITRATION: THE UNRESOLVED QUESTION OF PENDENT STATE CLAIMS

The modern trend toward binding commercial arbitration[1] recently received strong stimulus from the United States Supreme Court in *Shearson/American Express, Inc. v. McMahon*.[2] By transforming predispute securities arbitration provisions from mere options to arbitrate, exercisable at the customer's discretion, into binding and enforceable contracts, the Court's decision in *McMahon* will encourage the use of arbitration to resolve disputes previously adjudicated in court.[3]

The significance of the *McMahon* decision to securities arbitration lies primarily in the increased number of claims that now will be resolved through arbitration.[4] In holding that section 10(b)[5] of the Securities Exchange Act of 1934 (1934 Act)[6] did not preclude enforcement of a valid arbitration provision, *McMahon* will assuredly prompt an increase in the number of securi-

1. Arbitration is a process whereby parties voluntarily refer their disputes to an impartial third person, an arbitrator, selected by the parties. The arbitrator resolves the dispute based on the evidence and arguments presented before the arbitral tribunal. It is a "contractual proceeding whereby parties agree in advance that the tribunal's award will be final and binding upon them." G. WILNER, DOMKE ON COMMERCIAL ARBITRATION 1 (rev. ed. 1987). "Compulsory or binding arbitration . . . occurs when the consent of one of the parties is enforced by statutory provisions." R. RODMAN, COMMERCIAL ARBITRATION 2 (1984).

This Comment will focus on binding commercial arbitration, as opposed to labor arbitration. In addition, the statutory enforcement mechanism focused upon here will be the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1982) (FAA or the Act), not state arbitration statutes.

2. 107 S. Ct. 2332 (1987). For a discussion of *McMahon's* impact in hastening the trend toward arbitration of securities disputes, see Wall St. J., Sept. 11, 1987, at 1, col. 1 (reasoning that the likelihood of greater use of arbitration after *McMahon* prompted the Securities Exchange Commission's proposed modification of securities industry arbitration procedures); *see also* Letter from Richard G. Ketchum (Director of Market Regulation Division, Securities Exchange Commission) to all Securities Industry Conference on Arbitration (SICA) members (Sept. 10, 1987) [hereinafter SEC Letter].

3. *See* SEC Letter, *supra* note 2, at 1.

4. *Id.*; Shell, *Arbitration After the Crash*, Nat'l L.J., Mar. 21, 1988, at 13, col. 1 (discussing the impact of the Oct. 19, 1987 market crash on the volume of securities disputes resolved in arbitration); *see also* Rodriguez De Quijous v. Shearson/Lehman Bros., 845 F.2d 1296, 1299 (5th Cir. 1988) (construing *McMahon* as also supporting compelled arbitration of claims arising under the Securities Act of 1933, 15 U.S.C. § 77*l*(2) (1982)); Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 673 F. Supp. 1009, 1011 (C.D. Cal. 1987) (same).

5. 15 U.S.C. § 78j(b) (1982).

6. 15 U.S.C. §§ 78a-78kk (1982) [hereinafter 1934 Act].

ties disputes submitted to arbitration.[7] Moreover, growth in the number of securities disputes settled in arbitration promises to magnify problems with and heighten concerns about the adequacy of arbitration as an alternative to litigation.[8] Prominent among these concerns in the securities industry is the unavailability of punitive damages in arbitration.[9]

The attractiveness of the arbitration alternative relates directly to its perceived ability to protect investors' legal rights and remedies.[10] Furthermore, the popularity of securities arbitration, and its usefulness as an alternative dispute resolution mechanism depends largely upon the degree to which it provides claimants with a comparatively expeditious and inexpensive alternative to litigation.[11] However, to the extent that arbitral consideration excludes punitive awards, the process sacrifices both systemic efficiency and investor protection.

Fraudulent conduct in securities transactions does not give rise to punitive relief under federal securities law.[12] In contrast, most states allow punitive damage awards for particularly outrageous conduct.[13] Accordingly, to recover exemplary awards for fraudulent securities transactions, claimants often will join state fraud claims with causes of action under federal law.[14] When courts adjudicate such claims, the nature of the forum itself creates no obstacle to recovery of punitive relief on the pendent state claim.[15] Historically, however, submission of the same claims to an arbitral forum deprives the plaintiff of the opportunity to recover punitive damages on the pendent state claim.[16] Thus, a mere change of forum, from court to arbitration, not only alters the method of dispute resolution, but also restricts the recovery available to the claimant and limits the defendant's exposure to liability.

To the degree that arbitration alters the combination of remedies and sanctions afforded by state law, it modifies substantive law in ways unin-

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7. *See supra* note 2.

8. *See* SEC Letter, *supra* note 2, at 1.

9. *See generally* D. DOBBS, HORNBOOK ON REMEDIES 470 (1973); Stipanowich, *Punitive Damages in Arbitration:* Garrity v. Lyle Stuart, Inc. *Reconsidered,* 66 B.U.L. REV. 953 (1986) (discussing the history of punitive damage awards in arbitration and challenging the public policy rationale denying such awards).

10. *See* R. RODMAN, *supra* note 1, at 3.

11. *Id.* at 3-4.

12. *See* 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5, § 260.03[e] (2d ed. 1986). This Comment will focus exclusively on the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1982) [hereinafter Securities Act] and the 1934 Act, 15 U.S.C. §§ 78a-78kk (1982).

13. *See* Stipanowich, *supra* note 9, at 955 n.10.

14. Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims,* 29 DE PAUL L. REV. 693, 709 (1980).

15. *See infra* text accompanying notes 223-70.

16. *See infra* text accompanying notes 176-88.

tended by the drafters of the Federal Arbitration Act (FAA or the Act)[17] and interferes with the contractual expectations of parties to an arbitration agreement.[18] Furthermore, depriving arbitral panels of the authority to impose punitive sanctions on defendants guilty of outrageous and intentional wrongdoing will render such behavior unpunishable through civil litigation. Therefore, judicial exclusion of punitive damages from securities arbitration arguably functions both as an unapproved amendment to the FAA and as an impediment to effective private enforcement of the federal securities laws.

This Comment will begin with a brief overview of commercial arbitration, focusing on the accelerating trend toward enforcement of securities arbitration agreements leading up to and culminating in the Supreme Court's holding in *McMahon*.[19] Next, it will examine the availability of punitive damage awards and discuss their desirability when claimants join pendent state claims in arbitration with claims arising under the federal securities laws. Finally, this Comment will survey recent developments in securities arbitration and recommend changes consistent with the policies underlying both the FAA and federal securities law.

I. The Federal Arbitration Act

A. *Legislative Creation and Judicial Expansion*

American courts, like their English counterparts, traditionally viewed predispute arbitration agreements with skepticism and hostility.[20] To counteract this judicial attitude, Congress enacted the FAA.[21]

The FAA applies to a written arbitration provision contained in any contract involving interstate commerce[22] and places that contract "upon the same [legal] footing as other contracts."[23] In addition, the FAA vests federal district courts with the authority to resolve issues associated with the

17. 9 U.S.C. §§ 1-14 (1982); *see also infra* text accompanying notes 40-43.

18. *See infra* text accompanying notes 292-300.

19. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332 (1987).

20. *See generally* Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 Minn. L. Rev. 393 (1987); Krause, *supra* note 14.

21. Federal Arbitration Act, Pub. L. No. 68-401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-14 (1982)). "The Arbitration Act sought to overcome the rule of equity, that equity will not specifically enforce any arbitration agreement." Southland Corp. v. Keating, 465 U.S. 1, 13 (1984) (quoting *Hearings on S. 4213 and S. 4214 Before a Subcomm. of the Senate Comm. on the Judiciary*, 67th Cong., 4th Sess. 6 (1923) (statement of Sen. Walsh)).

22. 9 U.S.C. § 2. Section 2 provides that written arbitration agreements contained in contracts involving interstate commerce "shall be valid, irrevocable, and enforceable, save upon such grounds . . . as exist . . . for the revocation of any contract." *Id.*

23. Scherk v. Alberto-Culver Co., 417 U.S. 506, 510 (1974) (quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 1, 2 (1924)). Thus, the importance of contractual considerations becomes manifest. Standard defenses to the enforcement of contracts in general, such as unconsciona-

making of the arbitration agreement itself, or the enforcement thereof.[24] Furthermore, the Act specifies the statutory grounds for vacating an arbitral award.[25] Thus, the FAA vests federal district courts with authority to dispense court orders in three instances: to compel arbitration,[26] to stay litigation pending arbitration,[27] and to vacate an award granted in arbitration.[28]

Exercising its power of judicial review,[29] the Supreme Court clarified and arguably expanded[30] Congress' legislative assertion in the years following the FAA's enactment. In *Prima Paint v. Flood & Conklin Mfg. Co.*,[31] the Court affirmed the FAA's constitutionality[32] and proclaimed a federal district court's substantive authority under the Act as extending into contract law only over issues involving the making and performance of the arbitration clause itself.[33]

Effectively creating a presumption favoring arbitration, the Court in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*[34] held that the FAA established, "as a matter of federal law, [that] any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."[35] Indeed, where the arbitration agreement represents a written clause

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bility, apply to the arbitration provision itself, which is separable from the remainder of the contract. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 402-04 (1967).

24. 9 U.S.C. § 4. "Section 4 provides a federal remedy for a party 'aggrieved by the alleged failure, neglect or refusal of another to arbitrate under a written agreement for arbitration,' and directs the federal court to order arbitration once it is satisfied that an agreement for arbitration . . . [was] made and . . . not . . . honored." *Prima Paint Corp.*, 388 U.S. at 400.

25. 9 U.S.C. § 10. Because post-arbitration judicial examination of arbitral awards constitutes one of the two contexts for evaluating the availability of punitive relief, the scope of permissible court review becomes most significant. Under § 10, federal district courts may vacate an award upon proof of misconduct, fraud, or corruption in procuring the award as well as for failure to follow specified procedures. *Id.*

Absent misconduct, an arbiter's legal analysis or conclusions may form a basis for vacatur only if such interpretation meets the judicially-created "manifest disregard" standard first articulated in Wilko v. Swan, 346 U.S. 427, 436-37 (1953). However, the Supreme Court's discussion in *Wilko* provides little assistance in applying the standard, and subsequent interpretations similarly fail to define it precisely. *See generally* Lipton, *The Standard on Which Arbitrators Base Their Decisions: The SRO's Must Decide*, 16 SEC. REG. L.J. 3 (1988) (discussing conflicting interpretations given the "manifest disregard" standard).

26. 9 U.S.C. § 3.

27. *Id.* § 4.

28. *Id.* § 10; *see also supra* note 25.

29. Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177-78 (1803).

30. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 VA. L. REV. 1305, 1305 (1985) (tracing development and expansion of the FAA, a process the author refers to as its "federalization").

31. 388 U.S. 395 (1967).

32. *Id.* at 405.

33. *Id.* at 404.

34. 460 U.S. 1 (1983).

35. *Id.* at 24-25.

within a contract evidencing a transaction in interstate commerce, federal law governs "construction of the contract language itself," including questions of waiver and other contractual defenses to arbitration.[36]

In *Southland Corp. v. Keating,*[37] the Court extended the application of the Act into state courts, asserting the Act's dominance over contrary state law by requiring such courts to enforce valid arbitration agreements, even where state law specifically provided otherwise.[38] In *Southland,* the Court held that a California law requiring judicial consideration of a particular statutory claim directly conflicted with the FAA and was thus unenforceable under the Supremacy Clause.[39]

Further manifesting its emphasis on enforcing arbitration provisions, the Supreme Court held in *Dean Witter Reynolds Inc. v. Byrd*[40] that the FAA mandated arbitration of pendent state claims, even where costly bifurcated proceedings ensued.[41] In *Byrd,* the Court dismantled the practice of obtaining judicial consideration of otherwise arbitrable pendent state securities claims by "intertwining" the latter with nonarbitrable causes of action arising under the Securities Act of 1933 (Securities Act).[42] Because enforcement of valid arbitration agreements represented the primary purpose of the FAA, the Court's desire to give effect to that purpose surpassed its concerns about undermining the subsidiary goals of the Act, and of arbitration generally: less costly and more expeditious dispute resolution.[43]

Thus, by 1985, with the holding in *Byrd,* the Court resoundingly resolved questions regarding the scope of the FAA in favor of its broad and liberal application. *Byrd* demonstrated that Congress, through the FAA, had achieved its goal of reversing centuries of judicial hostility toward enforcement of predispute arbitration agreements. However, in the securities context, courts still routinely denied motions to compel arbitration pursuant to the Supreme Court's 1953 decision in *Wilko v. Swan.*[44]

B. Arbitration and Investor Protection

Judicial hostility to arbitration, combined with considerations of statutory construction and protection of investors[45] led the Supreme Court in *Wilko v.*

36. *Id.* at 25.
37. 465 U.S. 1 (1984).
38. *Id.* at 16.
39. *Id.*
40. 470 U.S. 213 (1985).
41. *Id.* at 217.
42. *Id.* at 216-17l; *see also* 15 U.S.C. §§ 77a-77bbbb.
43. *Id.* at 217.
44. 346 U.S. 427 (1953).
45. *Id.* at 434-38.

Swan to refuse enforcement of an otherwise valid predispute arbitration agreement.[46] In *Wilko*, the Court confronted a dispute presenting a "not easily reconcilable" conflict between the policies underlying the FAA and those of the Securities Act.[47]

In *Wilko*, a customer of the defendant brokerage firm alleged violations of section 12(2) of the Securities Act.[48] The defendant, pursuant to section 3 of the FAA, moved to stay trial pending arbitration.[49] The district court denied the stay, reasoning that the agreement deprived the buyer of his advantageous civil remedy under the Securities Act.[50] Reversing the trial court, the United States Court of Appeals for the Second Circuit concluded that the Securities Act did not prohibit enforcement of the agreement.[51]

The Supreme Court held that arbitration could not be compelled.[52] The majority's first rationale was statutory. The "special right" of recovery under section 12(2) of the Securities Act manifested a congressional intention to protect investors.[53] Section 14 of the Securities Act voids any "condition, stipulation, or provision binding any person . . . to waive compliance with any [of its] provision[s]."[54] Because the majority considered the arbitration agreement a stipulation waiving compliance with the provision giving the purchaser a right to select a judicial forum, section 14 rendered it void.[55] Hence, according to the majority, the customer could not compel arbitration.[56]

In addition to its statutory rationale, the Court expressed skepticism about arbitration in general. Stating that the "effectiveness" of the Securities Act's protections was "lessened in arbitration as compared to judicial proceedings,"[57] the Court considered the complexity of the statutory legal questions

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46. *Id.* at 438.
47. *Id.*
48. *Id.* at 428; *see also* 15 U.S.C. § 77*l*(2).
49. *Id.* at 429.
50. *Id.* at 429-30.
51. *Id.* at 430.
52. *Id.* at 438.
53. 15 U.S.C. § 77*l*(2). The Court considered the right of recovery under § 12(2) to be "special" for the following reasons. First, recovery for misrepresentation is easier under § 12(2) than under the common law because under § 12(2) the seller has the burden of proving lack of scienter. *Wilko*, 346 U.S. at 431. Second, the right is enforceable in any court, and § 12(2) prohibits removal from state court. *Id.* Third, the purchaser has a wide choice of venue if the case is brought in federal court. *Id.* Fourth, nationwide service of process is available to the purchaser. Finally, the minimum amount in controversy requirement of 28 U.S.C. § 1332 does not apply. *Id.*
54. 15 U.S.C. § 77n.
55. *Wilko*, 346 U.S. at 434-35.
56. *Id.* at 438.
57. *Id.* at 435.

implicated in a securities action, and the fact that arbitrators lacked legal training to resolve them.[58] In addition, the Court expressed concern over the severely limited nature of judicial review of arbitral decisions.[59] The Court concluded that these factors handicapped disputants to such an extent that, when added to the Court's statutory conclusions, congressional intention "concerning the sale of securities [would be] better carried out by holding invalid such an agreement."[60]

Following *Wilko*, lower courts extended its holding, denying compulsory arbitration to claims under sections 5 and 17 of the Securities Act.[61] Furthermore, courts found implied causes of action under the 1934 Act not arbitrable.[62] And, until recently, some courts refused to enforce predispute agreements to arbitrate claims arising under section 10(b)[63] of the 1934 Act and rule 10b-5,[64] promulgated thereunder. Although the Court had not expressly overruled *Wilko*, its rationale became the subject of close judicial scrutiny beginning in 1974 with the Supreme Court's decision in *Scherk v. Alberto-Culver Co.*[65]

Scherk involved a rule 10b-5 claim asserted in the context of an international securities transaction.[66] The defendant sought a stay pending arbitration.[67] The plaintiff opposed the stay, and moved to enjoin arbitration.[68] The district court granted plaintiff's injunction and the United States Court of Appeals for the Seventh Circuit affirmed, relying on *Wilko*.[69]

The Supreme Court reversed, holding *Wilko* inapposite.[70] The Court distinguished *Wilko* on two grounds. First, unlike the contract in *Wilko*, the agreement in *Scherk* resulted from arms-length negotiation by parties to an international agreement.[71] Second, the claim in *Scherk* arose under an im-

58. *Id.* at 435-36.

59. *Id.* at 436-37; *see also supra* note 25.

60. *Wilko*, 346 U.S. at 438.

61. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 297 (1984).

62. *See, e.g.*, Allegaert v. Perot, 548 F.2d 432 (2d Cir.), *cert. denied*, 432 U.S. 910 (1977); *see also* Katsoris, *supra* note 61, at 297-98.

63. 15 U.S.C. § 78j(b) (1982).

64. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5 constitutes the most popular federal securities remedy available to claimants. Robbins, *Securities Arbitration: Preparation and Presentation*, ARB. J., June 1987, at 3, 6.

65. 417 U.S. 506 (1974).

66. *Id.* at 509.

67. *Id.*

68. *Id.* at 509-10.

69. *Id.* at 510.

70. *Id.* at 517-18, 520-21.

71. *Id.* at 515 ("Such a contract involves considerations and policies significantly different from those found controlling in *Wilko*.").

plied cause of action under the 1934 Act rather than an express right of action like that invoked in *Wilko.*[72] Because the Court found the international context of the dispute "crucial,"[73] and the distinction drawn between implied and express causes of action significant,[74] *Scherk* appeared to cast doubt on the practice of refusing to compel arbitration of rule 10b-5 claims.

Undaunted by *Scherk,* however, lower courts attempted to limit its holding.[75] By either reading it as applying solely to international transactions,[76] or regarding its language distinguishing implied from express causes of action as dictum,[77] courts refused to consider the possibility that *Scherk* applied to domestic section 10(b) cases.[78] Accordingly, lower courts and commentators continued to consider rule 10b-5 claims nonarbitrable.[79]

The Court's increasingly hospitable attitude toward enforcing predispute arbitration agreements in the securities context expanded the FAA generally.[80] Having previously established the supremacy of the FAA over state law,[81] pendent state statutory or common law securities claims clearly became arbitrable.[82] Therefore, when a party joined an arbitrable state claim with a nonarbitrable federal securities claim, courts could either send both to arbitration, send both to court, or sever the claims, sending one to court and compelling arbitration of the other. The second of these options is commonly referred to as the doctrine of intertwining.[83]

Because arbitration panels[84] and federal securities statutes foreclosed recovery of punitive damages,[85] the practice of intertwining pendent state claims out of arbitration and into federal court became the sole method of

72. *Id.* at 513-14; *see also infra* note 74.

73. *Scherk,* 417 U.S. at 515.

74. Fletcher, *supra* note 20, at 411. Professor Fletcher notes that the distinction drawn in *Scherk* between actions implied from the 1934 Act and express causes of action in the Securities Act was a "basis for the holding, not obiter dictum." *Id.* This conclusion is supported both by the Court's "colorable argument" that *Wilko* was inapplicable in the context of the 1934 Act and by its closing explanation describing the holding. *Id.* Thus, *Scherk* called into question the applicability of *Wilko* to future, domestic § 10(b) claims.

75. *Id.* at 412-13.

76. *Id.* at 413.

77. *Id.*

78. *Id.*

79. *Id.*

80. *See generally* Hirshman, *supra* note 30.

81. Southland Corp. v. Keating, 465 U.S. 1 (1984).

82. *See infra* text accompanying notes 86-91.

83. Fletcher, *supra* note 20, at 414-15; *see also* Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 216-17 (1985).

84. Stipanowich, *supra* note 9, at 955-59.

85. *See* 5C A. JACOBS, *supra* note 12, § 260.03[e]; *see also* Krause, *supra* note 14, at 695-96.

obtaining exemplary relief in securities litigation. This practice proliferated[86] until the Supreme Court held in *Dean Witter Reynolds Inc. v. Byrd*[87] that district courts lacked discretion to deny enforcement of arbitration provisions through intertwining.[88] Both the majority opinion's emphasis on the purpose and legislative history of the FAA,[89] and Justice White's concurring opinion distinguishing *Wilko*,[90] presaged circumscription of compulsory arbitration, as articulated in *Wilko*.[91]

During the same term, the Supreme Court further restricted the grounds for denying application of the FAA. In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,[92] the Court held an international agreement to arbitrate claims arising under the Sherman Act enforceable.[93]

Mitsubishi's relevance to compulsory arbitration under the federal securities acts arises because like *Wilko*,[94] *Scherk*,[95] and *Byrd*,[96] it involved the applicability of the FAA to "claims arising out of [federal] statutes designed to protect a class to which the party resisting arbitration belongs."[97] First, the Court found in the FAA no "presumption against arbitration of statutory claims."[98] Furthermore, the Court held that courts should enforce arbitration agreements absent explicit congressional "intention to preclude a waiver of judicial remedies for the statutory rights at issue."[99] The judicial inquiry, then, involved an initial determination of whether the agreement itself was sufficiently broad to include resolution of the statutory claims and a secondary evaluation of "whether legal constraints external to the parties' agreement foreclosed . . . arbitration."[100] Finding no contractual obstacle in the clause itself, nor any statutory impediment to arbitral resolution of the antitrust claim, the Court enforced the arbitration provision.[101]

86. Krause, *supra* note 14, at 709.
87. 470 U.S. 213 (1985).
88. *Id.* at 218.
89. *Id.* at 219-21.
90. *Id.* at 224-25 (White, J., concurring).
91. *See generally* Comment, *Arbitrating Civil RICO and Implied Causes of Action Arising Under Section 10(b) of the Securities Exchange Act of 1934*, 36 CATH. U.L. REV. 455, 475-91 (1987) (analyzing circuit court split and accurately anticipating the Supreme Court's holding in *McMahon*).
92. 473 U.S. 614 (1985).
93. *Mitsubishi*, 473 U.S. at 629; Sherman Act, 15 U.S.C. §§ 1-7 (1982).
94. 346 U.S. 427 (1953).
95. 417 U.S. 506 (1974).
96. 470 U.S. 213 (1985).
97. 473 U.S. at 625.
98. *Id.*
99. *Id.* at 628.
100. *Id.*
101. *Id.*

The Court in *Mitsubishi* thus created the analytical framework for determining whether a federal statutory claim will prohibit arbitration. In addition, *Mitsubishi* disposed of several arguments traditionally invoked to deny enforcement of securities arbitration provisions. First, the public interest in enforcement of antitrust laws, arguably greater than that implicated in the majority of securities cases, constituted an insufficient obstacle to enforcement of the agreement.[102] Second, the complexity of the legal and factual issues involved in an antitrust suit did not mandate exclusion of such claims from arbitration.[103] Indeed, with respect to an arbitrator's ability to handle complex claims, the Court noted that "adaptability and access to expertise are hallmarks of arbitration."[104] Finally, despite the punitive treble damages remedy, the Court enforced the international arbitration agreement.[105] Thus, although the Court did not address the relevance of its conclusions to securities arbitration, it did rely heavily on those conclusions in its next major decision affecting the enforceability of securities arbitration agreements.[106]

In *Shearson/American Express, Inc. v. McMahon,*[107] the Court decided two issues regarding the enforceability of predispute arbitration agreements that divided the lower courts.[108] First, it held that claims arising under section 10(b) of the 1934 Act were arbitrable under the parties' valid predispute arbitration agreement.[109] Similarly, it held that the agreement was enforceable as to plaintiffs' claim under the Racketeer Influenced and Corrupt Orga-

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102. *Id.* at 636; *see also* Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense,* 2 CARDOZO L. REV. 481, 503-11, 516-21 (1981). Professor Sterk hypothesizes that the public policy defense to compelled arbitration should prevent enforcement of arbitration agreements "only in . . . areas where legal rules are designed to protect the interests of third parties or the public at large, and thus foster ends other than fairly resolving the dispute between the parties . . . ." *Id.* at 492-93. In the securities arena, Sterk found *Wilko* to be based "primarily on recognition that arbitration clauses in securities sales agreements generally are not freely negotiated" and that exceptions to the rule, such as the *Scherk* holding, bolstered this conclusion. *Id.* at 520. He concluded that the *Wilko* Court's refusal to enforce arbitration clauses had no relationship to the securities laws. *Id.* at 521.

103. *Mitsubishi,* 473 U.S. at 633.

104. *Id.*

105. *Id.* at 635. In describing the nature of the remedy under § 15 of the Sherman Act, the Court emphasized its remedial nature. Although it did recognize the provision's "important incidental policing function," the Court found that "so long as the prospective litigant effectively may vindicate it's statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and *deterrent* functions." *Id.* at 637 (emphasis added).

106. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2337 (1987).

107. *Id.* at 2332.

108. *Id.* at 2335.

109. *Id.* at 2343.

nizations Act (RICO).[110]

The respondents, customers of petitioner's brokerage firm, instituted the litigation.[111] The customers sued in federal court alleging state common law infractions, as well as violations of RICO, section 10(b) of the 1934 Act, and rule 10b-5.[112] The petitioner moved to compel arbitration under section 3 of the FAA, relying on the predispute arbitration agreement.[113]

Using the analytical structure developed in *Mitsubishi,*[114] the Supreme Court in *McMahon* turned first to the question of whether the party seeking to defeat application of the FAA had met its burden of demonstrating that Congress intended to exempt claims arising under the 1934 Act and RICO from the FAA's coverage.[115] The Court rejected petitioner's contention that section 29 of the 1934 Act[116] forbade waiver of the exclusive federal court jurisdiction over the 1934 Act claims granted by section 27.[117] Section 27 imposes no substantive statutory obligations with which persons must "com-

110. *Id.* at 2346; *see also* 18 U.S.C. §§ 1961-1968 (1982 & Supp. IV 1986) [hereinafter RICO].

This Comment is limited to the question of the availability of punitive damages in arbitration when state claims are joined with causes of action arising under the federal securities laws. *See supra* note 1. Thus, the arbitrability of RICO claims is beyond the scope of this analysis, except to the extent that the Court unanimously held that the punitive treble damages remedy available under RICO did not impede arbitration of such claims. *McMahon,* 107 S. Ct. at 2345. In holding RICO claims arbitrable, the Court relied heavily on *Mitsubishi* and its holding with respect to claims under § 4 of the Clayton Act, after which RICO was modeled. *Id.* Using the analytical approach set forth in *Mitsubishi,* the Court examined the RICO statute to determine whether its text, legislative history, or purpose evidenced congressional intent to prohibit arbitration of claims brought under the statute. *Id.* at 2343-46. Finding no such intention, the Court held the RICO claims arbitrable. *Id.* at 2346. Thus, *McMahon* and *Mitsubishi* represent two instances in which the Supreme Court expressly allowed arbitral consideration of punitive sanctions.

111. *McMahon,* 107 S. Ct. at 2336.

112. *Id.*

113. *Id.*

114. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985).

115. *McMahon,* 107 S. Ct. at 2337-38. *Mitsubishi* dictates this analytical approach. *See supra* text accompanying notes 92-101. The *McMahon* majority's formulation of this analysis placed "[t]he burden . . . on the party opposing arbitration . . . to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." *McMahon,* 107 S. Ct. at 2337. The party resisting arbitration must identify this intention in the "text, or legislative history . . . or from an inherent conflict between arbitration and the statute's underlying purposes." *Id.*

116. 15 U.S.C. § 78cc(a) (1982). Section 29 "declares void any condition, stipulation, or provision binding any person to waive compliance with any provision" of the 1934 Act. *McMahon,* 107 S. Ct. at 2338 (quoting 15 U.S.C. § 78cc(a)). In rejecting respondents' theory that, because predispute arbitration agreements are not freely negotiated, § 29 voids them, the Court noted that "[t]he voluntariness of the agreement is irrelevant to the [§ 29] . . . inquiry." *Id.* at 2339. Thus, the Court explicitly rejected the notion that *Wilko* and its progeny are premised on overreaching principles. *Id.*

117. 15 U.S.C. § 78aa. Section 27 grants United States district courts exclusive jurisdiction

ply," but merely grants jurisdiction over the 1934 Act claims to the federal courts.[118] Thus, the arbitration agreement did not constitute an agreement to waive "compliance" with section 27.[119]

The Court described *Wilko* as a product of that Court's "belief that a judicial forum was necessary to protect substantive rights created by the Securities Act."[120] Thus, "because arbitration was judged inadequate to enforce the statutory rights created by section 12(2)," the Court in *Wilko* held the arbitration clause void as a waiver of substantive rights.[121] Furthermore, the majority found support for this reading of *Wilko* in its prior holding in *Scherk*.[122]

According to Justice O'Connor, the decision in *Scherk* "turned on [that] Court's judgment that . . . arbitration was an adequate substitute for adjudication."[123] Thus, *Wilko* bars waiver of a judicial forum "only where arbitration is inadequate to protect the substantive rights at issue."[124]

The majority continued to focus on what it considered to be the "heart" of the Court's decision in *Wilko*: that arbitration "weaken[s]" claimants' ability to recover.[125] The *Wilko* majority's evaluation of the efficacy of arbitration was not based on "evidence" or "facts of which [it could] take judicial notice," but on a "general suspicion of the desirability of arbitration" and the "competence of arbitral tribunals."[126] Moreover, in light of the Supreme Court's expressions of confidence in arbitration since *Wilko*[127] and because of putative improvements in arbitration procedures and Securities Exchange Commission (SEC) oversight,[128] the assumptions regarding arbitration prevalent at the time of *Wilko* "do not hold true today."[129]

The majority dispensed with the respondents' final contention: that con-

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over violations of the 1934 Act and over "all suits in equity and actions at law brought to enforce any liability or duty created by [the] chapter." *Id.*

118. *McMahon*, 107 S. Ct. at 2338 (citing Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 2338-39.

123. *Id.* at 2339.

124. *Id.*

125. *Id.* at 2340.

126. *Id.* (quoting Wilko v. Swan, 346 U.S. 427, 439 (1953) (Frankfurter, J., dissenting)).

127. *Id.* (citing generally Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213 (1985); Southland Corp. v. Keating, 465 U.S. 1 (1984); Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1 (1983); Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).

128. *McMahon*, 107 S. Ct. at 2341 (noting the increased oversight authority of the SEC). *But see infra* text accompanying notes 142-48.

129. *McMahon*, 107 S. Ct. at 2341.

gressional failure to reject the extension of *Wilko* to section 10(b) claims constituted tacit legislative acceptance of such a practice.[130] By failing to reject judicial extension of *Wilko* during extensive revision of the 1934 Act,[131] respondents argued that Congress thereby expressed its intention that section 29(a) should continue to be interpreted as voiding otherwise valid predispute arbitration agreements.[132] However, Justice O'Connor stated that because the primary goal of the amendments was to "preserve the self-regulatory role of the securities exchanges," Congress did not address whether section 10(b) claims could be arbitrated.[133] Therefore, the 1975 amendments did not affect the holding in *Wilko,* and the majority divined no congressional intent to "bar enforcement of all predispute arbitration agreements."[134]

The dissent concurred that RICO claims were arbitrable but dissented with respect to causes of action under section 10(b).[135] Justice Blackmun, writing for the dissenters, focused on what the majority found to be the "heart" of *Wilko* and what he considered both decisive to and defective in the majority opinion: its view of the adequacy of arbitration procedures in protecting investors' rights.[136]

Justice Blackmun first disputed the majority's failure to find in the 1934 Act, with its primary goal of investor protection, an expression of congressional intent to bar application of the FAA.[137] Contending that the majority misread *Mitsubishi*, the dissent argued that the latter stood for the proposition that "the Securities Act constituted an exception to the Arbitration Act."[138] In addition, Justice Blackmun found *Wilko* not based on mistrust of arbitration, but on the "express language, legislative history, and purposes of the Securities Act."[139] Conceding that the adequacy of arbitration represented one ground for the holding in *Wilko,* Justice Blackmun emphasized that discussion of that element came *after* the Court had already concluded

130. *Id.* at 2343.

131. Securities Exchange Act of 1934, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

132. *McMahon,* 107 S. Ct. at 2342-43.

133. *Id.* at 2342.

134. *Id.* at 2343.

135. *Id.* at 2346 (Blackmun, J., concurring in part and dissenting in part) (joined by Brennan & Marshall, JJ.).

136. *Id.* at 2349-50 (Blackmun, J., dissenting).

137. *Id.* at 2350 (Blackmun, J., dissenting) ("[w]here the Court first goes wrong, however, is in its failure to acknowledge that the Exchange Act, like the Securities Act, constitutes" an exception to the FAA).

138. *Id.* (Blackmun, J., dissenting).

139. *Id.* at 2351 (Blackmun, J., dissenting).

that the Securities Act was an exception to the FAA.[140] Because both the Securities Act and the 1934 Act have the "same basic goal," Justice Blackmun concluded that *Wilko*'s rationale should also apply to section 10(b) claims to prevent compelled arbitration.[141]

Next, the dissent disputed the majority's optimistic assessment of the ability of arbitration to protect investors' statutory rights and questioned the adequacy of SEC oversight.[142] The characteristics of arbitration which the *Wilko* court found problematic remained.[143] In reviewing the changes in arbitration since *Wilko,* the dissent noted that the SEC—the body charged with oversight of securities arbitration—previously took the position that "10(b) claims . . . should not be sent to arbitration, that predispute arbitration agreements, where the investor was not advised of his right to a judicial forum, were misleading," and that "the . . . oversight upon which the Commission now relies could not alone make securities industry arbitration adequate."[144] Furthermore, even after the 1975 amendments, the SEC continued to find such agreements misleading and possibly actionable under the securities laws.[145] In addition, the SEC still lacked the authority to review specific arbitration proceedings.[146] Moreover, Justice Blackmun suggested that SEC oversight may even decrease due to its limited resources and because of currently high market activity.[147] Finally, given the established practice in the lower courts of refusing to enforce compulsory predispute arbitration provisions with respect to the 1934 Act claims, any changes in that practice should come from the legislature, not the judiciary.[148]

C. Federalized Securities Arbitration

Supreme Court decisions interpreting the FAA have "federalized" arbitration questions.[149] The Act applies to all written arbitration agreements evidencing a transaction in commerce and applies equally in state courts.[150]

140. *Id.* at 2352 (Blackmun, J., dissenting).
141. *Id.* at 2353 (Blackmun, J., dissenting).
142. *Id.* (Blackmun, J., dissenting).
143. *Id.* at 2353-58 (Blackmun, J., dissenting).
144. *Id.* at 2356 (Blackmun, J., dissenting).
145. *Id.* (Blackmun, J., dissenting).
146. *Id.* at 2357 (Blackmun, J., dissenting). Justice Blackmun briefly discussed Securities Exchange Commission (SEC) rule 15c-2-2, 17 C.F.R. § 240.15c-2-2 (1987). This rule, rescinded in the aftermath of *McMahon, see infra* note 303, prohibited the use of predispute arbitration agreements purporting to bind investors to arbitrate future disputes. *McMahon,* 107 S. Ct. at 2356 n.21 (Blackmun, J., dissenting).
147. *McMahon,* 107 S. Ct. at 2356 (Blackmun, J., dissenting).
148. *Id.* at 2359 (Stevens, J., concurring in part and dissenting in part).
149. *See* Hirshman *supra* note 30.
150. Southland Corp. v. Keating, 465 U.S. 1, 16-17 (1984).

Further, where state law or policy conflicts with the policies underlying the Act, the latter controls.[151] Even efficiency, one of the primary justifications for alternative dispute resolution in general, may not impede effectuation of the FAA's preeminent goal: enforcement of valid arbitration agreements.[152] Finally, neither the existence of a broad federal statutory framework, nor such framework's provision of punitive relief, necessarily constitute an exception to the FAA sufficient to deny its application.[153]

In *McMahon*, the Court asserted that arbitration procedures are sufficiently protective of a claimant's 1934 Act rights to compel arbitration of claims asserting those rights.[154] Thus, *McMahon* will probably transfer the majority of rule 10b-5 claims and, therefore most securities cases, from the federal courts to arbitral tribunals.[155] Given the *Byrd* Court's elimination of the practice of intertwining pendent state claims to nonarbitrable federal claims, the expansive reach of the FAA, and the general prohibition against punitive awards in arbitration, punitive relief in securities disputes may become a thing of the past. Although the Supreme Court has not considered whether arbitration under the FAA would permit punitive damage awards in such proceedings, a denial of punitive damage awards arguably interferes with arbitration's function of providing a substantially equivalent forum for dispute resolution[156] and the securities statutes' broad goal of investor protection.[157] Finally, denial of punitive damages in arbitration might weaken deterrence of already "outrageous" conduct on Wall Street by reducing or eliminating potential exposure to punitive liability.

II. ARBITRAL AWARDS

Courts generally award punitive damages[158] to deter, punish, and provide monetary incentive to bring suit against defendants engaging in outrageous

151. *Id.*

152. *See supra* text accompanying notes 40-43.

153. *See supra* text accompanying notes 97-98.

154. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2343 (1987).

155. *See supra* notes 2-8 and accompanying text.

156. Throughout the majority opinion in *McMahon*, the Court stressed the adequacy of arbitration in protecting claimants' statutory rights. 107 S. Ct. at 2339-41. Adequacy here refers to the degree to which the arbitration forum protects parties' substantive rights. *Id.* at 2339. Thus, if submission of a claim to an arbitral forum proceeding deprives parties of a remedy available in court, solely because of the nature of the forum, arbitration would presumably become an inadequate substitution for litigation.

157. *See, e.g., McMahon*, 107 S. Ct. at 2346 (Blackmun, J., dissenting); *see also* Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 611 n.1 (1985) (listing various damages recoverable under particular provisions of the securities laws).

158. RESTATEMENT (SECOND) OF TORTS § 908(1) (1977).

conduct.[159] Although courts have variously denominated the state of mind necessary to justify a punitive award,[160] all require a culpable mental state combined with outward misconduct.[161]

The existence of the requisite mental state and misconduct does not entitle a successful plaintiff to such an award as a matter of right, but merely vests in the trier of fact discretion to grant it.[162] Further, having granted the judicial trier of fact authority to award punitive damages, appellate review of such factual determination necessarily becomes limited.[163] Thus, the role of the trier of fact, whether exercised by judge or jury, is crucial and often determinative of punitive damage questions.

In arbitration, the arbitral tribunal replaces the traditional judicial trier of fact. Given the severely limited scope of judicial review of arbitral awards, remedies granted in arbitration are usually final.[164] Accordingly, attacks on punitive damage awards focus primarily on the scope of the parties' arbitration agreement[165] or the public policy goals generally underlying arbitration

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159. *Id.* § 908(2).

160. D. DOBBS, *supra* note 9, at 205 (listing various judicial descriptions of requisite mental states).

161. *Id.*

162. RESTATEMENT (SECOND) OF TORTS § 908 comment d (1977).

> Whether to award punitive damages and the determination of the amount are within the sound discretion of the trier of fact . . . . On the other hand, the trier of fact is not required to award punitive damages in a case in which they are permissible, and it is error for a trial judge to instruct the jury that punitive damages must be given.

Id.

163. *Id.* "The excessiveness of punitive damages . . . may be ground for reversal, for a new trial, or for remittur . . . ." *Id.; see also* D. DOBBS, *supra* note 9, at 218.

164. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2354 (1987) (Blackmun, J., dissenting) (listing statutory grounds under the FAA for vacating an arbitral award as well as the judicially-created "manifest disregard" standard for evaluating arbitrators' legal analysis); *see also supra* note 25.

165. An attack on the scope of the arbitration agreement itself is fundamentally a contractual argument in which one party contends that the agreement did not contemplate submission of punitive damage questions to arbitration. However, the typical arbitration agreement states that any dispute arising in connection with the business of the [broker] shall be arbitrated. UNIFORM CODE OF ARBITRATION § 12 (National Association of Securities Dealers 1987) [hereinafter Code]; *see also* Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 355 (N.D. Ala. 1984), *aff'd*, 776 F.2d 169 (11th Cir. 1985); Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 823 (M.D.N.C. 1983).

None of these arbitration forms specifically excludes consideration of a particular remedy or cause of action. On the contrary, the rules governing arbitration in the construction industry empower arbitrators to "grant *any* remedy or relief which is just and equitable and within the terms of the agreement of the parties." *Willoughby*, 598 F. Supp. at 357 (quoting CONSTRUCTION INDUSTRY ARBITRATION RULE 43). Unlike the construction industry rules, however, the Securities Industry Uniform Code gives arbitrators no guidance with respect to the substantive nature of the award. *See* Code § 41.

and punitive sanctions.[166]

A. Arbitration Procedures in the Securities Industry

Parties to a securities arbitration agreement may consent to resolve future disputes under the auspices of either the American Arbitration Association (AAA) or securities industry Self-Regulatory Organizations (SROs).[167] Most securities arbitration proceedings are conducted under SRO procedures as codified in the Uniform Code of Arbitration (Code).[168] Developed and adopted pursuant to SEC encouragement, the Code represents an attempt to standardize arbitration procedures in the securities industry.[169] Unlike arbitration under AAA supervision, however, SRO arbitration rules and practices remain nominally subject to SEC oversight.[170] Finally, although it lacks authority to overturn a particular award, the SEC does conduct periodic inspections of SRO arbitration files and investigates customer complaints about individual proceedings.[171]

The Code requires the SRO conducting the arbitration to appoint arbitrators, a majority of whom must be from outside the securities industry.[172] The Code contains further procedures designed to ensure the impartiality of the tribunal.[173] In addition, the Code allows retention of legal representa-

166. *See, e.g.*, Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976). For a more in-depth analysis of the public policy overlay to arbitrability questions, see generally Sterk, *supra* note 102 and Stipanowich, *supra* note 9.

167. Robbins, *supra* note 64, at 4. On September 1, 1987 the American Arbitration Association's recently adopted arbitration rules, COMMERCIAL ARBITRATION RULES (American Arbitration Assoc. 1988), tailored to the special needs of the securities industry, became effective. Friedman, *AAA's New Securities Arbitration Rules*, N.Y.L.J., Sept. 8, 1987, at 1, col. 1. In addition, in light of the Supreme Court's decision in *McMahon*, the SEC recently proposed major alterations in existing securities industry arbitration procedures. *See supra* note 2. The suggested revisions are necessary because "SRO-sponsored arbitration may become the *primary forum* for the resolution of disputes between broker-dealers and investors." SEC Letter, *supra* note 2, at 1-2 (emphasis added). Further, changes are necessary to increase public confidence in arbitration, to facilitate SEC oversight of arbitration and to enable Self-Regulatory Organizations (SROs) to more effectively handle complex cases. *Id.*

168. In 1986, disputants filed 2,850 cases with securities industry SROs, which adhere to the Code procedures. In the same time period, the American Arbitration Association received only 303 securities filings. Robbins, *supra* note 64, at 4-5.

169. Katsoris, *supra* note 61, at 283.

170. Robbins, *supra* note 64, at 5. For a critique of SEC oversight, see Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2346-59 (1987) (Blackmun, J., dissenting).

The SEC proposal to change arbitration rules was prompted to a considerable degree by the SEC's desire to more effectively oversee securities industry arbitration, which Justice Blackmun found inadequate. SEC Letter, *supra* note 2, at 1-2.

171. Robbins, *supra* note 64, at 5.

172. Katsoris, *supra* note 61, at 285. The SEC proposal advocates drastic changes in the composition and selection of arbitral panels. SEC Letter, *supra* note 2, at 2-7.

173. Katsoris, *supra* note 61, at 286.

tion, permits use of certain limited discovery procedures, and specifies permissible pleading practices.[174] Finally, it grants arbitrators broad discretion in evidentiary matters and requires recordation of the proceedings upon request.[175]

B. Obstacles to Punitive Damage Awards in Arbitration

The most significant obstacle to punitive damage awards in arbitration remains the public policy rationale as articulated in *Garrity v. Lyle Stuart, Inc.*[176] In *Garrity*, a dispute arose between an author and the publisher of her books.[177] The publishing agreements between the parties contained broad-form arbitration clauses.[178] The author obtained an arbitral award including punitive damages, and moved for its judicial confirmation. The publisher appealed, arguing that private arbitrators lack the authority to dispense punitive sanctions.[179]

In sweeping language, the majority vacated the arbitral award of punitive damages as against public policy.[180] The majority stressed that a punitive award is essentially a "social exemplary" remedy used to discourage and punish "public" wrongs.[181] As such, allowing arbitrators to grant punitive damages would violate one "purpose of the rule of law," the requirement that "the use of coercion be controlled by the State."[182] This principle

174. Robbins, *supra* note 64, at 5-6. The SEC proposal would expand current discovery practice by codifying the presently informal discovery procedures, using prehearing conferences and preliminary hearings for large cases, and permitting limited use of depositions. SEC Letter, *supra* note 2, at 10.

175. Katsoris, *supra* note 61, at 286. The SEC proposal recommends amending the Code to provide a "sufficient record for appellate courts to use for their review." SEC Letter, *supra* note 2, at 8. This record would be particularly useful when courts consider vacating an award under the developing "manifest disregard" standard. *See supra* note 25.

The proposal also recommends including a summary of certain information regarding arbitral awards, including relief sought and granted, in order to "balance out the inherently unequal familiarity with the system of investors and member firms." SEC Letter, *supra* note 2, at 8. If adopted, this provision would bring the question of punitive damages to the forefront. In subsequent review of an award for punitive damages granted on a common law fraud claim joined with a federal securities action, the reviewing court will be directly confronted with the issues dealt with by this Comment.

176. 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976); *see also* Note, *Arbitration: The Award of Punitive Damages as a Public Policy Question:* Garrity v. Lyle Stuart, Inc., 43 BROOKLYN L. REV. 546 (1976). *See generally* Stipanowich, *supra* note 9.

177. 40 N.Y.2d at 356, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

178. *Id.*, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

179. *Id.*, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

180. *Id.* at 360, 353 N.E.2d at 797, 386 N.Y.S.2d at 835.

181. *Id.* at 358, 353 N.E.2d at 795, 386 N.Y.S.2d at 833.

182. *Id.* at 359, 353 N.E.2d at 796, 386 N.Y.S.2d at 834 (citing H. KELSEN, GENERAL THEORY OF LAW AND STATE 21 (1945)).

would govern even if the parties had specifically agreed to arbitral consideration of punitive damage issues.[183]

First, "permitting an arbitrator whose selection is often restricted or manipulatable . . . to award punitive damages . . . displaces . . . the [s]tate, as the engine for imposing a social sanction."[184] Second, because judicial review is strictly limited, judicial supervision is usually unavailable to ensure the reasonableness of the arbitral award.[185] Finally, because arbitrators have no practical guidelines to inform their decisions, the basis of the exemplary damage determination consists of "subjective criteria involved in attitudes toward correction and reform." Courts, therefore, should not entrust this evaluation to private arbitrators.[186]

The dissent reached a contrary conclusion, finding the three-pronged analysis of a prior case applicable to justify imposition of a penal sanction.[187] After finding these criteria satisfied, the dissent concluded that courts should not intervene here, but only where the "public interest clearly supersedes the concerns of the parties."[188]

An emerging common law trend,[189] as well as a significant number of commentators, forcefully challenges the holding in *Garrity*.[190] The most comprehensive judicial rejection of its holding and rationale to date came in *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*[191] *Wil-*

183. *Id.* at 357, 353 N.E.2d at 795, 386 N.Y.S.2d at 833.

184. *Id.* at 358, 353 N.E.2d at 796, 386 N.Y.S.2d at 833.

185. *Id.*, 353 N.E.2d at 796, 386 N.Y.S.2d at 834 (quoting Publishers' Ass'n v. Newspaper & Mail Deliverers' Union, 280 A.D. 500, 503, 114 N.Y.S.2d 401, 404 (1952)).

186. *Id.* at 359, 353 N.E.2d at 796, 386 N.Y.S.2d at 834 (quoting Publishers' Ass'n v. Newspaper & Mail Deliverers' Union 280 A.D. 500, 503, 114 N.Y.S.2d 401, 404 (1952)).

187. *Id.* at 362-63, 353 N.E.2d at 799, 386 N.Y.S.2d at 836 (Gabrielli, J., dissenting) (citing Matter of Associated Gen. Contractors, N.Y. State Chapter, Inc., 36 N.Y.2d 957, 959, 353 N.E.2d 859, 859, 373 N.Y.S.2d 555, 556 (1975)). Judge Gabrielli found the following factors sufficient to allow imposition of a punitive award: presence of a broad-form arbitration clause, absence of third party interests, and lack of legislative articulation of a policy against punitive damages. *Id.* at 363, 353 N.E.2d at 799, 386 N.Y.S.2d at 837 (Gabrielli, J., dissenting).

188. *Id.* at 365, 353 N.E.2d at 800, 386 N.Y.S.2d at 838 (Gabrielli, J., dissenting). This is roughly equivalent to the framework posited by Professor Sterk. *See supra* note 102.

189. *See* Stipanowich, *supra* note 9, at 957 n.15 (compiling cases). Among the more recent cases recognizing arbitral imposition of punitive damages in a commercial context are: Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 360 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (contractual dispute in construction industry); Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 824 (M.D.N.C. 1983) (securities fraud claim); Rodgers Builders, Inc. v. McQueen, 76 N.C. App. 16, 28-29, 331 S.E.2d 726, 734 (1985) (contractual dispute in construction industry); Baker v. Sadick, 162 Cal. App. 3d 618, 631, 208 Cal. Rptr. 676, 684 (1984) (medical malpractice claim).

190. *See, e.g.*, Stipanowich, *supra* note 9; *see also* Hirshman, *supra* note 30, at 1360-63; Sterk, *supra* note 102, at 527-33.

191. 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

loughby involved a dispute arising from a contractor's cancellation of a construction contract that contained a broad-form arbitration provision.[192] Alleging several common law tort and contract claims, the subcontractor brought suit in Alabama state court.[193] The contractor removed to federal court and entered a motion for a stay pending arbitration.[194] Following an arbitral award against it, the defendant sought vacatur of the punitive damage element of the award.[195] The court denied the contractor's motion and confirmed the arbitral award.[196]

The court's opinion rejected the *Garrity* rationale upon which the contractor's arguments rested.[197] The contractor first contended that the arbitration clause itself was too narrow to empower arbitrators to award punitive damages.[198] While noting that the parties could have expressly restricted the arbitrators' authority,[199] the district court followed the Supreme Court's admonition to construe the agreement by "resolving all doubts in favor of the arbitrator's authority."[200] The court considered this principle especially relevant with respect to the authority of the arbitrators to flexibly fashion appropriate remedies.[201] Thus, the FAA's policy of resolving, in favor of arbitration, doubts as to both the scope of arbitrable issues and the breadth of arbitrators' remedial authority mandated rejection of defendant's contention that the contract involved in *Willoughby* precluded a punitive damage award.[202]

The court next confronted the proposition that public policy concerns prohibit arbitral consideration of punitive awards.[203] First, the court noted that the rationale in *Garrity* derived from state, not federal, law and policy.[204] Because the FAA applied to "written contract[s] evidencing a transaction in interstate commerce," federal law governed not only the categories of claims subject to arbitration but also the "resolution of issues concerning the arbitration provision's interpretation, construction, validity, revocability

192. *Id.* at 355.
193. *Id.*
194. *Id.*
195. *Id.* at 356.
196. *Id.* at 365.
197. *Id.* at 356.
198. *Id.*
199. *Id.* at 357.
200. *Id.* (citing Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 25 (1983)).
201. *Id.* at 357.
202. *Id.* at 358-59.
203. *Id.* at 359.
204. *Id.*

and enforceability."[205] Therefore, only conflicting federal policy or legislation could defeat the validity of an otherwise valid agreement to arbitrate.[206] Finding no federal policy prohibiting punitive damages, the court upheld the arbitrator's award.[207]

The court's examination of federal policy regarding punitive damages directly challenged the rationale of *Garrity*. First, the arbitrator's authority derived from the parties' agreement.[208] That contract, like most commercial arbitration agreements, broadly covered all disputes arising from the contract.[209] Clearly, plaintiff's tort claims related to the parties' construction contract, and claims of fraudulent conduct, except in procurement of the arbitration provision itself, were arbitrable.[210] Because the panel possessed the authority to resolve the tort claim, denying it the ability to grant a traditional remedy for such a claim would be "anomalous."[211]

The final segment of the *Willoughby* opinion focused on the deleterious results that might flow from a per se rule denying punitive damages in arbitration.[212] First, restricting an arbitrator's flexibility would "undermine the value and sufficiency of the arbitral process."[213] While recognizing that arbitrators might abuse their authority, the court concluded that such a possiblity did not justify denying punitive damages in all circumstances.[214] Second, because arbitrators are by nature familiar with the practices in the industry in which the dispute arises, they are at least as competent as a court in identifying "outrageous" commercial practices and in determining what amount of punitive damages would suffice to deter or punish such behav-

205. *Id.* at 359 (quoting Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 823-24 (M.D.N.C. 1983)); *see also supra* note 22.

206. *Willoughby,* 598 F. Supp. at 360.

207. *Id.* at 361. "[T]here [is] 'no public policy reason persuasive enough to justify prohibiting arbitrators from resolving issues of punitive damages submitted by the parties.' " *Id.* (quoting Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 824 (M.D.N.C. 1983)). In *Willis,* the court compelled arbitration of securities claims over the plaintiff's objection that the agreement did not encompass fraud claims or the prayer for punitive relief. Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 822, 824 (M.D.N.C. 1983). The court first determined that the arbitration clause, covering "any controversy," encompassed not only the tort claims, but also the prayer for punitive relief. *Id.* at 824. Finding no federal policy against arbitral consideration of the punitive damage question, the court compelled arbitration. *Id.* at 825.

208. *Willoughby,* 598 F. Supp. at 357.

209. *Id.* at 355.

210. *Id.* at 356 (citing Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967)).

211. *Id.* at 362.

212. *Id.* at 362-65.

213. *Id.* at 363.

214. *Id.* at 362.

ior.[215] Barring arbitrators from awarding damages commensurate with how they, as experts, measure the gravity of the wrong, would prevent them from applying their special expertise, the basis of their selection.[216] Moreover, considering an agreement to arbitrate a waiver of the plaintiff's right to punitive damages[217] would thwart the purposes of punitive awards and encourage "grossly unjustified conduct . . . by making it more economically feasible."[218] Finally, adherence to the *Garrity* rule would require twin proceedings where parties joined tort and contract claims.[219]

Willoughby articulates the proposition that federal policy is the only relevant consideration in determining whether punitive relief is allowable under the FAA.[220] Because the Supreme Court's decision in *Southland Corp. v. Keating*[221] precludes state policy impediments from restricting the operation of the FAA, obstacles to arbitration must be of federal magnitude.[222]

C. Remedies Available Under Federal Securities Law

In judicial fora, punitive damage awards are not available in causes of action arising under express liability provisions of the federal securities acts.[223] Moreover, courts prohibit such awards in causes of action implied from those provisions.[224] However, exemplary awards are available in court when litigants join pendent state claims with federal claims where the underlying state law so provides.[225] Given the likelihood that the majority of future securities disputes will attain resolution in arbitral fora,[226] the availability of punitive remedies in arbitration represents a crucial issue in the securities industry.

Most securities arbitration provisions evidence a transaction in interstate commerce and, thus, become enforceable under the FAA.[227] In determining

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215. *Id.* at 363.

216. *Id.*

217. *Id.* In Baselski v. Paine, Webber, Jackson & Curtis, Inc., 514 F. Supp. 535, 543 (N.D. Ill. 1981), the court rejected plaintiffs' argument that their arbitration agreement with the defendant was unconscionable because its enforcement would result in "forefeiture" of their "right" to punitive damages. The court held that by agreeing to have New York law govern the agreement, they "contractually waived their 'right' to punitive damages." *Id.*

218. *Willoughby,* 598 F. Supp. at 363.

219. *Id.* at 364.

220. *Id.* at 365; *see also* Hirshman, *supra* note 30, at 1360-63.

221. 465 U.S. 1 (1984).

222. Hirshman, *supra* note 30, at 1360-63.

223. 5C A. JACOBS, *supra* note 12, § 260.03[e].

224. *Id.*

225. *See infra* text accompanying notes 259-63.

226. *See supra* notes 2-8 and accompanying text.

227. *See* Fletcher, *supra* note 20, at 401.

the arbitrability of a given issue, the FAA resolves all doubts in favor of enforcing the arbitration provision.[228] A similar presumption favors granting arbitrators broad remedial authority, commensurate with the cause of action before them.[229] Moreover, only "clear and express [federal] exclusions" should restrict arbitration of a given cause of action and arbitrators' authority to remedy it.[230]

Clearly, state policy impediments, such as a rule prohibiting arbitral consideration of punitive damage claims, are insufficient to deny arbitration.[231] In addition, although punitive awards remain unavailable for causes of action arising under the federal securities acts,[232] the United States Supreme Court has not faced the question of whether the federal policy denying punitive damage awards under the federal securities laws would apply to pendent state claims joined in an arbitral forum.

To resolve this question, the goals of the implicated federal cause of action must be examined.[233] The general purposes of the federal securities laws are to protect investors[234] and maintain market efficiency.[235]

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.[236] Section 28(a) of 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.[237]

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228. Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983).

229. *See supra* text accompanying notes 214-19.

230. Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 358 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) (quoting Willis v. Shearson/Am. Express, Inc., 569 F. Supp. 821, 823 (M.D.N.C. 1983)).

231. *See* Hirshman, *supra* note 30, at 1360-63.

232. *See* Easterbrook & Fischel, *supra* note 157, at 611 n.1. (cataloging available remedies).

233. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2338 (1987).

234. *Id.* at 2353 (Blackmun, J., dissenting).

235. Easterbrook & Fischel, *supra* note 157, at 613. Professor Fischel and Judge Easterbrook submit the damage provisions of the federal securities laws to economic analysis (the "economics of sanctions"). *Id.* at 612. They evaluate damage rules in terms of their effectiveness in deterring unwanted behavior without imposing undue costs on the market through unwarranted deterrence or excessive enforcement costs. *Id.* Though some offenses may be "efficient" in that their commission, and the resulting payment of damages may produce an optimal allocation of resources, intentional torts should be unconditionally deterred by punitive damage awards. *Id.* at 622.

236. *See supra* text accompanying notes 99-100.

237. 15 U.S.C. § 78bb(a) (1982). In pertinent part, § 28(a) states: "the rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist in law and equity but no person . . . shall recover . . . a total amount in excess of his actual damages." *Id.*

In *Green v. Wolf Corp.*,[238] the United States Court of Appeals for 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.[239] Finding "little aid in the legislative history" of section 28(a), the court sought to construe the provision to effectuate its purpose.[240]

First, the court found no support in the 1934 Act for plaintiff's contention that the implied cause of action should have "all of the attributes of common law fraud."[241] Because imposition of liability under rule 10b-5 went "beyond the limits of the common law," the court found that equation of the two with respect to damages was unjustifiable.[242]

Second, the effects of imposing exemplary damages would confound the goals of the 1934 Act.[243] The burden of such an award against a publicly held corporation would fall on innocent shareholders.[244] In addition, compensatory awards granted through class actions or derivative suits already provide adequate incentive to sue.[245] Moreover, the availability of such actions, as well as criminal sanctions under the 1934 Act, fulfill the deterrent purposes that punitive damages serve in other contexts.[246] Therefore, because the 1934 Act effectuates the purposes of exemplary awards without resort to punitive damages, and because such awards would harm some shareholders in attempting to protect others, the court considered punitive damages neither desirable nor necessary to carry out the 1934 Act's purposes.[247]

In *Globus v. Law Research Service, Inc.*,[248] the same court prohibited punitive damage awards under a cause of action implied from section 17 of the Securities Act. The court analyzed the question in terms of the function punitive damages might serve in enforcing the Securities Act.[249]

First, the court found additional sanctions unnecessary for effective en-

238. 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

239. *Id.* at 303.

240. *Id.* at 302 n.17. The legislative history cited by the court reads: "This subsection reserves rights and remedies existing outside of those provided in the [1934] Act, but limits the total amount recoverable to the amount of actual damages." H.R. REP. No. 1383, 73d Cong., 2d Sess. 28 (1934).

241. *Green*, 406 F.2d at 303.

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

248. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

249. *Id.* at 1284.

forcement of the Securities Act.[250] As in *Green*, the court catalogued the "arsenal of weapons" available to plaintiffs seeking to enforce their statutory rights.[251] Considering the powerful deterrents that criminal sanctions, compensatory awards, and class actions supply, the added deterrence provided by punitive damage awards would not justify imposition of "potentially awesome injuries" on the offending party.[252] Second, the court expressed concern about its inability to restrict punitive awards in future causes of action arising from the same conduct.[253] Finally, permitting punitive damages would create an "unfortunate dichotomy" between the two federal securities acts.[254] Such an approach would preclude courts from treating them as a "single comprehensive scheme of regulation" and would result in providing one remedy to injured buyers and another, lesser remedy to injured sellers.[255]

Taken together, *Globus* and *Green* forcefully articulate a rationale for denying exemplary awards for violation of either of the federal securities acts. Although *Globus* reserved the question of whether section 28(a) prohibits "punitive damages in a pendent common law fraud claim joined to an action based on the 1934 Act,"[256] the Second Circuit provided a negative response to that query in *Flaks v. Koegel*.[257]

In *Flaks*, the plaintiff joined claims under the Securities Act and the 1934 Act with causes of action under New York common law.[258] In summarily holding exemplary damages recoverable on common law claims in such a context, the court relied heavily on commentary and cases outside of the Second Circuit.[259] Of the cases relied upon, *Young v. Taylor*[260] offers the most detailed analysis of section 28(a)'s effect on pendent state claims.

Young involved joinder of a federal claim under the 1934 Act with state common law and blue sky allegations.[261] The court construed section 28(a) to operate both as a savings clause preserving rights and remedies under state law, as well as a ceiling limiting the maximum amount of damages

250. *Id.* at 1285.
251. *Id.*
252. *Id.*
253. *Id.*
254. *Id.* at 1286.
255. *Id.* Because "the 1934 Act is the only basis upon which a defrauded seller of securities could obtain relief," a rule allowing punitive damages for violation of the Securities Act would grant buyers punitive damages, but, considering its holding in *Green*, deny it to sellers. *Id.*
256. *Id.* at 1286 n.11.
257. 504 F.2d 702 (2d Cir. 1974).
258. *Id.* at 704.
259. *Id.* 706-07.
260. 466 F.2d 1329 (10th Cir. 1972).
261. *Id.* at 1331.

allowable.[262] Thus, while allowing a claimant to "use any combination of non-statutory and statutory remedies . . . [under section 28(a)] he is not allowed more than the maximum amount recoverable" under any one of them.[263]

Courts generally have followed the interpretation given section 28(a) in *Flaks* and *Young*.[264] No court has prohibited punitive damages on pendent state claims by virtue of the federal securities acts' operation.[265] It is therefore apparent that neither section 28(a) nor a more general federal policy deriving from the federal securities laws operate to preclude punitive damages in pendent state claims. Thus, because no federal policy prohibits courts from awarding punitive damages on pendent claims, no "clear and express exclusions" exist that are sufficient to preclude granting such awards in arbitration.

The *Green* court's concerns about bankrupting corporations to the detriment of innocent shareholders lack sufficient foundation in many contexts. Indeed, its concern for innocent shareholders appears misplaced in corporations that are not publicly-held.[266] Similarly, with respect to causes of action under the 1934 Act, where the defendant often is not affiliated with the issuer, the *Green* court's concerns about innocent shareholders are not relevant. Furthermore, because arbitral panels are less likely than juries to award punitive damages, the perceived dangers in vesting arbitrators with this authority is less threatening.[267] Moreover, the FAA authorizes judicial review to vacate improper arbitration awards, including those granted in "manifest disregard" of the law.[268] In any event, arbitrators could take these concerns into account.[269] Finally, even assuming that punitive damage awards would violate the policies underlying the federal securities acts in some situations, such potential provides little justification for an absolute

262. *Id.* at 1338.

263. *Id.*

264. *See* 5C A. JACOBS, *supra* note 12, § 260.03[e] (citing cases and commentary).

265. *Id.*

266. *See* Note, *Securities Regulation—Damages—The Possibility of Punitive Damages as a Remedy for a Violation of Rule 10b-5,* 68 MICH. L. REV. 1608, 1624 (1970).

267. Robbins, *supra* note 64, at 13. "Many brokerage firms do not discourage a panel from entertaining punitive damage claims because they are confident that sophisticated arbitrators will be able to see through emotional arguments unsupported by facts." *Id.* Further, "[a]s a general rule, arbitrators with the power to award punitive damages will not be as inclined to award them as a jury would be." *Id.* (quoting Phillip J. Hoblin, Jr., general counsel to Shearson Lehman Bros.); D. ROBBINS, RESOLVING SECURITIES DISPUTES—ARBITRATION AND LITIGATION 348 (1986).

268. *See supra* note 25.

269. Indeed, should the securities industry adopt the SEC proposal to provide instruction to arbitrators, SEC Letter, *supra* note 2, at 4, arbitrators could more effectively take these factors into account.

prohibition.[270]

III. Consequences of an Absolute Rule

An absolute rule denying arbitrators authority to award punitive damages in securities disputes would undermine the purposes of the FAA. Though the FAA sanctions such a result where congressional intent clearly commands,[271] the legislative history of the securities acts does not demonstrate this intention with respect to punitive damages.[272] Indeed, an absolute rule would reward egregious misconduct, thereby undermining the protection provided investors and impairing the efficiency of the securities markets.[273]

A. Congressional Intent and Supreme Court Precedent

Congress' preeminent motivation in enacting the FAA was to mandate enforcement of valid arbitration provisions.[274] The primary justification for providing private parties with the option to arbitrate, enforceable through the FAA, inheres in the speed and efficiency yielded by arbitral dispute resolution.[275]

Courts adhering to state public policy prohibitions against punitive damage awards in arbitration, against arguably definitive Supreme Court precedent,[276] attempt to impose such prohibitions both before and after arbitral disposition of the claim. Before arbitration, a federal district court might deny a motion to compel arbitration pursuant to section 4 of the FAA, due to the presence of a prayer for punitive relief. This kind of denial would clearly conflict with congressional intent and Supreme Court interpretation thereof.[277] In addition, denial would withhold the practical benefits of arbitration from the party seeking enforcement and would therefore conflict with the secondary purposes of the FAA.

As an alternative, federal court might impose a punitive damage prohibition after the fact by vacating the punitive portion of the award.[278] How-

270. Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 362 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

271. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2338 (1987).

272. *See supra* note 207.

273. *See, e.g.*, Miley v. Oppenheimer & Co., 637 F.2d 318, 332 (5th Cir. 1981).

274. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 219-20 (1985).

275. *Id.* at 220.

276. Southland Corp. v. Keating, 465 U.S. 1, 14 (1984); *see also* Hirshman, *supra* note 30, at 1360-63.

277. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2337 (1987). "The Arbitration Act thus establishes a federal policy favoring arbitration . . . requiring that we rigorously enforce agreements to arbitrate." *Id.* (citations omitted).

278. *See supra* note 25.

ever, the same conflict would arise with the purposes of the FAA when a court issues an order denying a motion compelling arbitration. In addition, such a practice might expand the standard of review beyond that contemplated by either the FAA or Supreme Court interpretations thereof.[279] Although section 10(d) of the FAA does provide for an award to be vacated if the arbitrators exceed their powers,[280] the Supreme Court previously held that arbitrators may consider tort claims.[281] Given this interpretation, denying arbitrators authority to provide relief commensurate with the cause of action before them would not only be "anamolous,"[282] but would render arbitration less effective than courts in protecting claimants' rights.[283] Thus, denying such authority to arbitrators would defy congressional intent and undermine Supreme Court precedent.

To defeat application of the FAA, the Supreme Court in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*[284] required a showing of congressional intent to exempt a given claim from the Act's application.[285] The federal securities acts evidence no such intent with respect to pendent claims for punitive relief.[286] On the contrary, section 28(a) of the 1934 Act expresses congressional respect for existing state claims and remedies by explicitly providing for their preservation.[287] Thus, refusing to preserve punitive remedies available under state law would not only confound the purposes of the FAA, but would directly contravene the express mandate of the 1934 Act.

B. Policies Underlying Punitive Remedies

A rule enforcing an arbitration clause, but prohibiting arbitrators from considering punitive damage claims, would also frustrate the policies underlying and purposes served by punitive damage awards.[288] Automatic immunity from punishment would encourage intentional wrongdoing by increasing its profitability.[289]

Denying arbitrators authority to consider punitive damage claims would

279. *Id.*
280. 9 U.S.C. § 10(d) (1982).
281. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 406-07 (1967).
282. Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 362, *aff'd*, 776 F.2d 269 (11th Cir. 1985).
283. *See supra* note 156.
284. 473 U.S. 614, 628 (1985).
285. *See supra* notes 114-19 and accompanying text.
286. *See supra* text accompanying note 265.
287. *See supra* text accompanying note 263.
288. *See supra* text accompanying notes 158-61.
289. *See supra* note 157.

eviscerate the deterrent, penal, and incentive functions provided by such awards and would allow defendants engaging in outrageous conduct to escape otherwise applicable penalties.[290] Thus, rather than providing a forum equally protective of parties' rights, arbitration might degenerate into a haven for the intentional tortfeasor and a "trap for the unwary."[291]

C. *Informing Private Expectations*

In addition to conflicting with the FAA and the 1934 Act, an absolute denial of punitive damages in arbitration would frustrate parties' expectations in signing an arbitration contract. Judge Gabrielli's dissent in *Garrity v. Lyle Stuart, Inc.*[292] and the majority opinion in *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*[293] describe how parties' rights under the FAA would suffer from an absolute denial of punitive damages in arbitration. First, denial of arbitration due to the existence of a punitive damage claim would interfere with the parties' freedom to contractually determine the manner of resolving future disputes. Precluding arbitration would not only entail disregarding their contractual rights, but the cost savings and expedition parties seek in submitting a claim to arbitration would disappear. Although Judge Gabrielli would approve of a result "where the public interest clearly supercedes," he found that punitive damage awards do not sufficiently implicate such interests.[294]

The majority in *Willoughby* also stressed the importance of contractual considerations in determining whether arbitrators possessed the authority to award punitive damages.[295] Where an arbitration clause places no limits on the remedial authority of the tribunal, federal policy prohibits courts from implying them.[296] Indeed, failure to broadly construe arbitration clauses in favor of granting arbitrators expansive remedial authority would undermine the FAA by enforcing fewer arbitration agreements. Further, denial of arbitration may deprive one party of the benefit of his bargain. Assuming that inclusion of an arbitration provision and the prospect of enjoying the benefits of arbitrating future disputes influenced an individual's decision to enter into an agreement, that individual would lose the benefit of his bargain and become bound to an arrangement he did not contemplate.

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290. *See* Robbins, *supra* note 64, at 13-14.

291. Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 360, 353 N.E.2d 793, 797, 386 N.Y.S.2d 831, 835 (1976) (Gabrielli, J., dissenting).

292. *Id.* at 360-65, 353 N.E.2d at 797-800, 386 N.Y.S.2d at 835-38 (Gabrielli, J., dissenting).

293. 598 F. Supp. 353, 353 (1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

294. *Garrity*, 40 N.Y.2d at 365, 353 N.E.2d at 800, 386 N.Y.S.2d at 838.

295. *See supra* text accompanying notes 198-202.

296. Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983).

Second, a policy absolutely denying access to arbitration for parties seeking punitive damages would decrease the value of arbitration as a dispute resolution mechanism generally. Such a policy would necessarily reduce the number and types of claims resolvable through arbitration, in contravention of federal policy and Supreme Court precedent. Any given case might even "require two trials—one before the arbitrator and then a separate judicial trial on essentially the same facts."[297] Thus, in addition to undermining the FAA's primary purpose of enforcing valid arbitration provisions, a *Garrity*-type prohibition would eliminate the "chief advantages and purposes of arbitration—to resolve congestion in the courts and to achieve a quick, inexpensive and binding resolution of all disputes that arise between parties to an agreement."[298]

Because the Supreme Court has yet to rule on the availability of punitive relief for pendent state claims in securities arbitration, a real possibility exists that a securities purchaser may, in signing an arbitration contract, surrender his right to pursue exemplary damages. Indeed, *Garrity*[299] would seem to portend this result and at least one federal court has followed its mandate.[300] Therefore, absent statutory or judicial assurance, the SEC should step forward and alert claimants of the possible implications of agreeing to arbitrate future securities disputes.[301]

Indeed, the SEC has acted preemptively to protect investors in the past. The SEC's recently abandoned requirement of notice that claims brought under the Securities Act may be nonarbitrable[302] reflected similar concerns.[303] In addition, its recent proposal to improve securities arbitration procedures arose from its responsibility to ensure the fairness of and public confidence in arbitral proceedings.[304] Moreover, the SEC has the authority

297. *Willoughby*, 598 F. Supp. at 364 (citations omitted).

298. *Id.*

299. Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976).

300. Baselski v. Paine, Webber, Jackson & Curtis, Inc., 514 F. Supp. 535, 543 (N.D. Ill. 1981).

301. *See* Shell, *supra* note 4, at 14, col. 1 ("the SEC and SICA [Securities Industry Conference on Arbitration] should see to it that arbitration is explained rather than sneaked by customers").

302. 17 C.F.R. § 240.15c-2-2 (1982) (rescinded by 52 Fed. Reg. 39,216 (1987)).

303. 52 Fed. Reg. 39,216 (1987). After noting that the Supreme Court's decision in *McMahon* made predispute arbitration agreements enforceable with respect to 1934 Act claims, the SEC found that "notice and public procedures are unnecessary in the public interest because Rule 15c-2-2 is no longer appropriate in light of case law developments." *Id.* at 39,217. Rule 15c-2-2 had codified the SEC's "longstanding view" that clauses purporting to bind customers to arbitration were inconsistent with the deceptive practice prohibitions of § 10(b) and § 15(c) of the 1934 Act. 48 Fed. Reg. 53,406 (codified at 17 C.F.R. § 240.15c-2-2 (1986)).

304. *See* SEC Letter, *supra* note 2, 1.

under section 19(c) of the 1934 Act[305] to require SROs to adopt its proposal.[306]

A rule requiring member firms to provide notice to customers of the possibility that, in agreeing to arbitrate, they may forfeit the possibility of recovering punitive damages, would serve the purpose of the securities acts by promoting fairness and equalizing the negotiating positions of customers and broker-dealers.[307] Furthermore, it would effectuate the FAA's purposes by encouraging specification of the nature of the authority granted to arbitrators by the agreement. Customers could then either bargain for explicit language allowing arbitrators to consider punitive damage claims, or make a fully informed decision to the contrary.

Alternatively, the SEC could propose amendments to SRO rules that would explicitly state what types of remedies arbitrators may grant.[308] Unlike other industry-specific arbitration rules,[309] the Code is silent on the types of awards available to parties to an arbitral proceeding.[310] Informing investors of available remedies would decrease the uncertainty with which even knowledgeable investors approach a decision to accept a predispute arbitration provision.

IV. CONCLUSION

No explicit legislative or United States Supreme Court judicial direction exists with respect to the availability, in arbitration, of punitive relief on state claims joined with allegations of violations of federal securities laws. Recent Supreme Court decisions, however, clarify the breadth of the FAA and articulate the Court's view of the adequacy of securities arbitration in protecting claimants' statutory rights.[311] Thus, state-based impediments do not suffice to deny arbitration or to restrict the authority of arbitrators to flexibly fashion appropriate remedies.[312]

Similarly, the Court's requirement that exceptions from application of the

305. 15 U.S.C. § 78s(c) (1982).

306. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2341 (1987). "In short, the Commission has broad authority to . . . *mandate the adoption of any rules it deems necessary* to ensure that arbitration procedures adequately protect statutory rights." *Id.* (emphasis added).

307. *See* Sterk, *supra* note 102, at 517-18; *see also* Shell, *supra* note 4, at 14, col. 1; *supra* note 116.

308. *See supra* text accompanying notes 304-06.

309. *See supra* note 165.

310. *Id.*

311. *See supra* notes 156.

312. *See* Hirshman, *supra* note 30, at 1360-63.

FAA rest on manifest congressional intent[313] cannot be met with respect to claims arising under either the federal securities laws or state claims appended thereto.[314] Indeed, explicit statutory language in the 1934 Act mandates preservation of state-based remedies.[315] Thus, federal statutory obstacles to awarding punitive damages in arbitration are also absent.

Given the absence of federal statutory impediments to awarding punitive damages in securities arbitration, federal policy concerns provide the final possible rationale for denying punitive damages on pendent state claims. Assuming that mere policy concerns justify interference with the powerful statutory mandate of the FAA, those concerns raised in the context of securities arbitration should not warrant denying enforcement of otherwise valid arbitration provisions. First, most federal policy concerns remain either unfounded or alleviable through instruction of the arbitration panels.[316] Indeed, the Supreme Court has twice found the presence of punitive sanctions in federal statutes insufficient to preclude compelled arbitration of claims based upon those statutes.[317] Second, to the degree that arbitrators are less likely than jurors to grant punitive relief, claimants in arbitration would already surrender remedies available in court—even if arbitrators received explicit authorization to award punitive damages.[318] Moreover, disallowing punitive remedies in arbitration would frustrate the investor-protection policy of the federal securities laws by rewarding intentional wrongdoing and reducing the effectiveness of private enforcement of the federal securities laws. Finally, denial of punitive damages in securities arbitration would make arbitration a refuge for intentional tortfeasors, rather than an efficient and potentially equitable method of dispute resolution.

Thomas J. Kenny

313. Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332, 2338 (1987).
314. *See supra* text accompanying notes 258-70.
315. *Id.*
316. *See supra* notes 266-70 and accompanying text.
317. *See supra* note 110.
318. *See supra* note 267.