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PUNITIVE DAMAGES IN NEW YORK ARBITRATION: WHO IS REALLY BEING PUNISHED?

*Barbier v. Shearson Lehman Hutton, Inc.*¹

I. INTRODUCTION

Promotion of settlement to reduce litigation is a well-established policy goal in our federal court system.² However, when parties cannot resolve all of their disputes in alternative dispute resolution, this policy goal is undermined. In arbitration governed by the law of the state of New York, parties are generally unable to resolve all of their disputes in arbitration when punitive damages would be warranted. In most cases, the parties' dispute cannot be fully resolved where punitive damages would be available because an arbiter is not free to award punitive damages in arbitration under New York law. This is particularly troublesome because the law of the state of New York is often chosen to govern agreements in a number of industries. For example, New York law is routinely incorporated into investment agreements because New York is the world's nerve center for that industry. This Casenote will explore the ramifications of the New York approach to punitive damages in arbitration and will propose an approach which may be more in-line with the policy goals of our judicial system.

II. FACTS AND HOLDING

This case is an appeal from a judgment entered by the United States District Court for the Southern District of New York, which confirmed an arbitral award of compensatory and punitive damages based on the defendants' unauthorized investment of plaintiffs' assets.³ On January 7, 1986, the Barbiers entered into a written agreement with Shearson and opened an investment account.⁴ Pursuant to the parties' agreement, Shearson's broker, Bendelac, would trade securities for the Barbiers after receiving the Barbiers' authorization of each trade.⁵ On October 18, 1988, having learned that Bendelac entered trades which were not

1. 948 F.2d 117 (2d Cir. 1991).

2. *Williams v. First Nat'l Bank*, 216 U.S. 582, 595 (1910); *United States v. McInnes*, 556 F.2d 436, 441 (9th Cir. 1977); see also FED. R. EVID. 408 advisory committee's note.

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

4. *Id.* at 119.

5. *Id.*

authorized by them and that their investment was thereby diminished, the Barbiers filed a Statement of Claim with the Arbitration Tribunal of the New York Stock Exchange.⁶ The Barbiers pursued claims for conversion, breach of contract, and negligence and/or recklessness.⁷

Pursuant to the parties' contract, which contained an arbitration agreement,⁸ the Barbiers' claims were submitted to arbitration, where a unanimous arbitration panel awarded the Barbiers \$130,645 compensatory damages and \$25,000 punitive damages.⁹ The Panel apportioned \$31,129 of the award to Shearson and \$124,516 to Bendelac.¹⁰

On June 12, 1990, the Barbiers filed a petition for confirmation of the arbitration award in district court.¹¹ Each defendant filed separate motions to vacate the award, stating that, *inter alia*, the arbitration panel exceeded its authority in awarding punitive damages.¹² On December 3, 1990, the district court approved the arbitration award in its entirety and denied the defendants' motions to vacate.¹³ Defendant Bendelac appealed the decision to the U.S. Court of Appeals for the Second Circuit, stating that the district court erred in awarding the plaintiffs punitive damages.¹⁴ Bendelac asserted that the district court erred in awarding punitive damages because New York law does not allow arbiters to award punitives.¹⁵ Bendelac supported this contention by stating that because jurisdiction was based on diversity, the *Erie* doctrine required the application of New York law.¹⁶ Further, Bendelac directed the court's attention

6. *Id.*

7. *Id.*

8. Paragraph 13 of the parties' agreement contained an arbitration clause which stated that: This agreement shall be . . . governed by the laws of the state of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [the Barbiers'] accounts, to transactions with [Shearson, its] officers, directors, agents and/or employees for [the Barbiers] or; to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Board of Directors of the New York Stock Exchange, Inc. as [the Barbiers] may elect . . . Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.

Id. at 119.

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.* at 120. Defendant Bendelac also appealed the compensatory damage award. *Id.* The court of appeals found no merit in this contention, stating that the district court's holding was not clearly erroneous. *Id.* at 121. The court's analysis of Bendelac's contentions involving the compensatory damages portion of the award does not provide any significant change in the law. Thus, compensatory damages will not be addressed in this Casenote in order to focus upon the appellate court's treatment of punitive damages.

15. *Id.* at 121.

16. *Id.*

to New York case law and the holding in *Garrity v. Lyle Stuart, Inc.*,¹⁷ which stated that an arbitrator may not award punitive damages.¹⁸

The Barbiers contended that the arbitration award, including the amount awarded for punitive damages, should be upheld.¹⁹ The Barbiers asserted that application of the *Garrity* rule conflicted with federal substantive law and was thereby "preempted" by the Federal Arbitration Act²⁰ and, thus, could not be applied in the determination of this case.²¹

The Second Circuit Court of Appeals affirmed the portion of the judgment relating to compensatory damages and reversed that part of the decision which granted the plaintiffs punitive damages.²² The court directed the district court to enter judgment for the plaintiffs in the amount of \$104,516 plus interest.²³ The court held that punitive damages may not be awarded in arbitration where jurisdiction is based on diversity of citizenship and when the parties have agreed that New York State law governs their dispute.²⁴

III. LEGAL BACKGROUND

The availability of punitive damages in arbitration revolves around competing policy goals. The policy goals in conflict include punishment and deterrence of malicious behavior; promotion of settlement; enforcement of the intent of parties who have reduced their agreement to writing; promotion of the enforceability of arbitration agreements; and preservation of the right to punish by the state. The manner in which these policy objectives are incorporated into the law are outlined below. The New York approach to the availability of punitive damages in arbitration is addressed first, followed by approaches in other jurisdictions.

17. 353 N.E.2d 793 (N.Y. 1976).

18. *Barbier*, 948 F.2d at 120-21; see *Garrity*, 353 N.E.2d at 794.

19. *Barbier*, 948 F.2d at 121.

20. 9 U.S.C. §§ 1-15 (1988) [hereinafter FAA].

21. *Barbier*, 948 F.2d at 121.

22. *Id.* at 123.

23. *Id.*

24. *Id.* at 122.

A. The New York Approach

The availability of punitive damages in arbitration governed by New York law is a complex and unsettled area of law.²⁵ As shall be seen, policy objectives have driven the developing case law.

As a general proposition, New York substantive law provides that punitive damages may be awarded in circumstances involving wanton and willful conduct.²⁶ However, when the dispute is being resolved outside of the court system, the availability of punitive damages is curtailed.²⁷ In *Garrity*, the New York Court of Appeals held that punitive damages may not be awarded in arbitration.²⁸ Even where the parties had expressly provided for punitive damages in their agreement, the court stated that the award of punitives is not allowed in arbitration.²⁹

The court offered a policy-based rationale to support its decision in denying punitive damages in the arbitration setting. First, the court found that an award of punitive damages in arbitration violates public policy.³⁰ The court stated that public policy dictates that the award of punitive damages is reserved exclusively to the state through the court system because punitive damage awards are very similar in character to the imposition of criminal sanctions.³¹ The court reasoned that because punitive damages are intended to punish, as are criminal sanctions, the award of punitive damages should be left exclusively to the state through the court system.³²

The court's second policy rationale is grounded in traditional notions of contract law.³³ The court found that a punitive damage award based on arbitration arising out of a contract is improper because, historically, punitive damages have not been awarded for a breach of contract.³⁴

The next major decision refining the availability of punitive damages in arbitration under New York law was *Fahnestock & Co. v. Waltman*.³⁵ The decision in *Fahnestock* both expanded and constricted the availability of punitive

25. Stephen H. Kupperman & George C. Freeman III, *Selected Topics in Securities Arbitration: Rule 15c2-2, Fraud, Duress, Unconscionability, Waiver, Class Arbitration, Punitive Damages, Rights of Review, and Attorney's Fees and Costs*, 65 TUL. L. REV. 1547, 1601 n.318 (1991).

26. *Id.* at 1599 (citing *Getty Petroleum Corp. v. Island Trans. Corp.*, 878 F.2d 650, 657 (2d Cir. 1989); *Smith v. Bolt Prod., Inc.*, 861 F.2d 363, 371 (2d Cir. 1988); *Borkowski v. Borkowski*, 355 N.E.2d 287, 287 (N.Y. 1976)).

27. *Garrity*, 353 N.E.2d at 794.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* at 794, 797.

32. *Id.* at 794, 796-97.

33. *Id.* at 795.

34. *Id.*

35. 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991), and *cert. denied*, 112 S. Ct. 1241 (1992).

damages based on ambiguities left open in *Garrity*. These changes in the availability of punitives, as explored in the *Fahnestock* decision, are addressed below.

Fahnestock plugged a number of holes in the *Garrity* decision, which seemed to allow punitive damages in limited circumstances in arbitration under New York law.³⁶ First, *Fahnestock* rejected the contention that when arbitration falls under the auspices of the FAA, federal substantive law preempts state law.³⁷ Parties seeking punitive damages argued that when an agreement falls within the FAA, federal substantive rules (which allow punitives) apply and state rules do not.³⁸ Thus, if the *Fahnestock* court had accepted this argument, FAA preemption of New York law would allow punitives in arbitration even where the parties' agreement stated that New York law (which does not allow punitives) governed the agreement.³⁹ The *Fahnestock* court rejected this argument stating that the policy behind the FAA was to create a body of federal substantive law to prevent states from interfering with the enforceability of arbitration agreements.⁴⁰ The court stated that the New York policy of disallowing punitives in arbitration does not conflict with provisions of the FAA, thus federal substantive law does not preempt state law.⁴¹

Fahnestock similarly closed the argument that federal substantive law applies where no choice-of-law clause exists.⁴² Such an approach would allow an arbitrator to award punitive damages.⁴³ In rejecting this interpretation, the court found that when federal jurisdiction is based on diversity of citizenship, the *Erie* doctrine requires the law of the forum state to control.⁴⁴ Thus, in a federal court located in New York, the substantive law of New York provides the rule of decision.⁴⁵ As stated previously, New York law does not allow punitive damages in arbitration.⁴⁶

Finally, the *Fahnestock* court rejected the contention that a choice-of-law clause intends to incorporate the New York arbitration law but not the New York substantive law.⁴⁷ The court stated that although the *Garrity* decision is grounded in state policy concerns, it is no less a rule of state substantive law.⁴⁸

36. *Id.* at 517-18.

37. *Id.* at 517.

38. *Id.* (citing *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)).

39. *Id.*

40. *Id.* (citing *Volt Information Sciences v. Board of Trustees*, 489 U.S. 468, 477 (1989)).

41. *Id.*

42. *Id.* at 518.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

Therefore, the court chose to apply the *Garrity* rule that punitive damages are not available in arbitration governed by New York law.⁴⁹

The *Fahnestock* decision limited the availability of punitive damages where the *Garrity* decision was ambiguous. However, the *Fahnestock* court also expanded the availability of punitives in certain situations. *Fahnestock* both explicitly and implicitly presents situations where punitive damages are available in arbitration under New York law.⁵⁰

The court first stated that punitive damages may be awarded in arbitration under New York law where the arbitration claim is based on a RICO statute.⁵¹ The court noted that, in such cases, jurisdiction is based on federal question.⁵² Thus, by basing the allowance of punitive damages on the federal question jurisdiction, the court implied that other federal statutes which create federal question jurisdiction and provide for punitive damages may also create situations where punitive damages may be awarded in arbitration under New York law.⁵³

Secondly, *Fahnestock* continued to open the door for the availability of punitive damages by stating that punitive damages may be awarded when the parties explicitly provide for such in their agreement.⁵⁴ In so holding, the *Fahnestock* court overruled that portion of the *Garrity* decision which held that punitives are not available even when provided for in the parties' agreement.⁵⁵ The *Fahnestock* court reasoned that this portion of *Garrity* interfered with the enforceability of arbitration agreements and was therefore in conflict with federal substantive rules.⁵⁶ Most importantly, the court implied that federal substantive law can preempt New York state law on the issue of the availability of punitive damages in arbitration, leaving open the possibility of total deterioration of the *Garrity* rule.⁵⁷

Thirdly, the *Fahnestock* court noted two other related theories which allow punitives in New York arbitration.⁵⁸ The court noted that punitives may be available when arbitration takes place in New York but only where the substantive law of the state named in the parties' choice-of-law clause allows for punitives in

49. *Id.*

50. *Id.* at 518-19.

51. *Id.* at 519 (citing *Kerr-McGee Ref. Corp. v. M/T Triumph*, 924 F.2d 467, 470 (2d Cir. 1991)). In *Kerr-McGee*, the plaintiff, in arbitration, was awarded treble damages based on the RICO Act, 18 U.S.C. §§ 1961-1968 (1884). *Kerr-McGee*, 924 F.2d at 470.

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

53. *Id.*; see also *Kupperman & Freeman*, *supra* note 25, at 1601-02 n.318.

54. *Fahnestock*, 935 F.2d at 518; see *Garrity*, 353 N.E.2d at 794 (where the court found that punitive damages are not available even if the parties had explicitly provided for them in their agreement).

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

56. *Id.*

57. *Id.*

58. *Id.* at 519.

arbitration.⁵⁹ Similarly, the court found that punitives may be awarded in arbitration where the rules governing the arbitration allow them.⁶⁰

In sum, the availability of punitive damages in arbitration under New York law requires thorough analysis. It can be said with certainty that punitives are available when the parties provide for them in their agreement, when based on a RICO statute, or when the rules governing the arbitration allow for them. Implicitly, punitives are also available when a statute creating federal-question jurisdiction provides for them or where a party can show willful or wanton conduct. However, outside of the situations outlined above, punitive damages are unavailable in arbitration under New York law.

B. Approaches in Other Jurisdictions

Jurisdictions outside of New York present a wide spectrum of approaches in addressing the availability of punitive damages in arbitration. Some jurisdictions allow arbiters complete freedom to award punitives, while other jurisdictions do not allow punitives in any situation. The policies which drive the various approaches are discussed below.

Those jurisdictions which do not allow punitive damages in arbitration reason that the award of punitives in arbitration violates public policy.⁶¹ Some of these courts follow the *Garrity* rationale that the award of punitives is preserved to the state through the court system.⁶² In *United States Fidelity & Guaranty v. DeFluiter*,⁶³ the Indiana Court of Appeals offered a slightly different public policy rationale, stating that parties cannot contract to gain a benefit or suffer a loss from the issuance of punitive damages.⁶⁴ At this time, eight jurisdictions prohibit the award of punitive damages in arbitration.⁶⁵

In the federal system, an arbiter's award of punitive damages is generally allowed.⁶⁶ The most thorough and well-reasoned federal opinion in support of allowing punitives to be granted by arbiters comes from the Eleventh Circuit in

59. *Id.*

60. *Id.* Commentators have noted that punitive damages may be available in arbitration under New York law where a party can prove fraud or some other type of wanton or willful conduct which is associated with the arbitration agreement. See Kupperman & Freeman, *supra* note 25, at 1601 n.318.

61. See, e.g., *United States Fidelity & Guar. Co. v. DeFluiter*, 456 N.E.2d 429, 431 (Ind. Ct. App. 1983); *Shaw v. Kuhnel & Assocs.*, 698 P.2d 880, 882 (N.M. 1985).

62. Margaret P. Sullivan, Comment, *The Scope of Modern Arbitral Awards*, 62 TUL. L. REV. 1113, 1133 (1988); see also *supra* notes 30-32 and accompanying text.

63. 456 N.E.2d 429.

64. *Id.* at 432; see also Sullivan, *supra* note 62, at 1133.

65. Sullivan, *supra* note 62, at 1128 (citing JAMES D. GHIARDI & JOHN J. KIRCHER, 1 PUNITIVE DAMAGES LAW AND PRACTICE § 4.01 (1985 & Supp. 1987)). The jurisdictions which do not allow punitive damages in arbitration include Connecticut, Georgia, Indiana, Massachusetts, Michigan, Nebraska, and Washington. *Id.*

66. *Id.* at 1133.

the case of *Willoughby Roofing & Supply v. Kajima International, Inc.*⁶⁷ *Willoughby* stands for two propositions: (1) arbiters should be granted broad powers in fashioning remedies including the power to award punitive damages;⁶⁸ and (2) federal arbitration law controls the issue of whether punitives may be granted by an arbiter.⁶⁹ The rationale enunciated in *Willoughby* is representative of the rationale presented by other federal courts. Therefore, the federal court system policy rationales supporting the *Willoughby* propositions are addressed in the context of this touchstone case.⁷⁰

In *Willoughby*, the court first held that arbiters should be granted broad power and flexibility in crafting remedies to resolve disputes.⁷¹ In support of this position, the court stated that federal policy promotes liberal construction of arbitration agreements.⁷² Further, the court buttressed its position by recognizing that ambiguities in the parties' agreement are resolved in favor of allowing the arbiter to decide the issue.⁷³ Thus, based on policy concerns, the court concluded that to foster the federal policy of promotion of settlement, arbiters must be granted broad powers and flexibility in crafting remedies.⁷⁴ The court concluded that such power and flexibility must include the power to award punitive damages; otherwise settlement is inhibited because the arbiter is restricted in fashioning a remedy.⁷⁵

Secondly, the *Willoughby* decision examined the proposition that federal arbitration law, rather than state law, controls the issue of whether an arbiter may award punitive damages.⁷⁶ This prong of the opinion illustrates the New York approach.⁷⁷ The *Willoughby* court found that federal arbitration law controls the categories of claims which may be arbitrated and that punitive damages are

67. 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985).

68. *Id.* at 357-58.

69. *Id.* at 360.

70. *See generally id.* at 357-64. The arbitration clause in question in the *Willoughby* case provided:

All claims, disputes, and other matters in question arising out of, or relating to, this Agreement . . . or the breach thereof . . . shall be resolved by arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association unless the parties mutually agree otherwise. This agreement to arbitrate shall be specifically enforceable under the prevailing arbitration law . . .

Id. at 355.

71. *Id.* at 357.

72. *Id.* (citing *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 585 (1960)).

73. *Id.* (citing *Moses H. Cone Memorial Hosp.*, 460 U.S. at 24 (1983); *Lackawanna Leather Co. v. United Foods & Commercial Workers*, 706 F.2d 228 (8th Cir. 1983); *Daniel Constr. Co. v. International Union of Operating Eng'rs, Local 513*, 570 F. Supp. 299 (E.D. Mo. 1983), *aff'd*, 738 F.2d 298 (8th Cir. 1984)).

74. *Id.* (citing *United Steelworkers of Am. v. Enterprise Wheel & Car Corp.* 363 U.S. 593, 597 (1960)).

75. *Id.*

76. *Id.* at 360.

77. *See id.* at 359; *see also supra* notes 25-60 and accompanying text.

included in the category which can be arbitrated.⁷⁸ Thus, the court held that even where a choice-of-law clause provides that a certain state's law should control the agreement, federal arbitration law instead controls and allows the punitive damages issue to be included in the arbitration.⁷⁹ Therefore, even if the substantive law of the state preferred by a choice-of-law clause does not allow for punitive damages, federal arbitration law will override the state law and allow punitive damages.⁸⁰

The *Willoughby* court addressed additional rationales advanced by federal courts which support the availability of punitive damages in arbitration. The court noted that in disallowing punitive damages in arbitration, parties are in effect waiving their right to such an award.⁸¹ The court stated that such an approach undermines the value of arbitration in resolving disputes⁸² and further runs afoul of the purpose of punitive damages, which is to foster the policy goal of deterrence and punishment of malicious behavior.⁸³

Finally, the court noted that cutting off a party's ability to pursue punitive damages in arbitration is inefficient.⁸⁴ The court offered the example where both a contract and tort claim arise out of the parties' agreement.⁸⁵ In such a situation, the contract claim is submitted and fully decided by arbitration.⁸⁶ However, a tort claim which includes a punitive damages issue must be decided by a court.⁸⁷ The court found that the necessity of utilizing two different forums to resolve one dispute based on essentially the same facts was wasteful.⁸⁸ The court stated that this result undermines the main utility of arbitration — the reduction of congestion in the court system and quick and inexpensive resolution of all disputes.⁸⁹ Thus, the court stated that another solution is to allow punitives in arbitration where the parties have agreed to arbitrate.⁹⁰

78. *Id.* at 359-60 (citing *Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Moses H. Cone Memorial Hosp.*, 460 U.S. at 24-25; *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967); *Ultracashmere House Ltd. v. Meyer*, 664 F.2d 1176, 1179-80 (11th Cir. 1981); *Tullis v. Kohlmeyer*, 551 F.2d 632 (5th Cir. 1977); *Willis v. Shearson/American Express, Inc.*, 569 F. Supp. 821, 823-24 (M.D.N.C. 1983)).

79. *Id.* at 359-60.

80. *Id.*

81. *Id.* at 363 (citing *Baselki v. Paine, Webber, Jackson & Curtis*, 514 F. Supp. 535, 543 (N.D. Ill. 1981)).

82. *Id.*

83. Sullivan, *supra* note 62, at 1128 (citing GHIARDI & KIRCHER, *supra* note 65, §§ 4.13-.16).

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

85. *Id.* at 363-64 (citing Richard P. Hackett, Note, *Punitive Damages in Arbitration: The Search for a Workable Rule*, 63 CORNELL L. REV. 272, 299 (1978)).

86. *Id.* at 364; Hackett, *supra* note 85, at 299.

87. *Willoughby*, 598 F. Supp. at 363-64.

88. *Id.* at 363-64; Hackett, *supra* note 85, at 299.

89. *Id.* at 364 (citing *Ultracashmere House Ltd.*, 664 F.2d at 1179); see also Kupperman & Freeman, *supra* note 25, at 1597.

90. *Willoughby*, 598 F. Supp. at 365.

IV. THE INSTANT DECISION

The *Barbier* court first analyzed the district court's confirmation of the arbiter's award of compensatory damages,⁹¹ then addressed the punitive damages award.⁹² The court held that an arbiter may not award punitive damages where jurisdiction is based on diversity of citizenship and where the parties themselves have agreed that the law of the state of New York shall govern any disputes between them.⁹³ The punitive damages portion of the arbitration award was reversed by the appellate court.⁹⁴

In analyzing the legitimacy of the district court's confirmation of the arbitral award of punitive damages, the appellate court faced the key issue of whether to apply the *Garrity* rule.⁹⁵ In determining whether to apply the *Garrity* rule, the court relied on the *Fahnestock* holding.⁹⁶ In *Fahnestock*, the parties' arbitration clause was silent as to the arbiter's ability to award punitive damages.⁹⁷ The court in that case stated that where the parties do not address the punitive damages issue, state law, rather than federal substantive law is to be followed in determination of the case.⁹⁸

In the instant decision, the court found that the *Garrity* rule applied because the parties expressly agreed that the law of the state of New York would govern any dispute under the contract.⁹⁹ Plaintiffs contended that federal substantive law should apply because of the policy goals underlying the adoption of the FAA,¹⁰⁰ which provides that federal substantive law should apply where state law inhibits the enforceability of an arbitration agreement.¹⁰¹ In rejecting the Plaintiffs' argument, the court reasoned that the FAA preempts state law only where state law is in direct conflict with the FAA.¹⁰² The court found that no such conflict existed and that the *Garrity* rule should apply, therefore vacating the arbitral award of punitive damages.¹⁰³

91. *Barbier*, 948 F.2d at 120. The focus of this Casenote is on the appellate court's treatment of the district court's confirmation of the award of punitive damages. The appellate court's decision is not significant in regard to the compensatory portion of the award. Therefore, the appellate court's reasoning in affirmation of the compensatory portion of the award does not merit attention for the purposes of this Casenote.

92. *Id.* at 121.

93. *Id.* at 122.

94. *Id.* at 123.

95. *Id.* at 121; see *Garrity*, 353 N.E.2d at 794.

96. *Barbier*, 948 F.2d at 122.

97. *Id.* at 121.

98. *Id.* at 121-122.

99. *Id.* at 122.

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

The court next addressed the Plaintiffs' contention that the choice-of-law clause in the parties' agreement applied only to state substantive law and not to arbitration law.¹⁰⁴ In rejecting this construction, the court reasoned that damage measures are issues of state law.¹⁰⁵ The court further stated that the fact that damage measures are based on state policy concerns did not make it any less a rule of substantive law.¹⁰⁶ Thus, the court found that because the choice-of-law clause goes to state substantive law, the *Garrity* rule applied and the district court's confirmation of the arbiter's award of punitive damages must be vacated.¹⁰⁷

Finally, the court recognized that arbitration awards can only be vacated in select circumstances, such as when arbiters exceed their powers.¹⁰⁸ The court reasoned that because New York law does not allow an arbiter to award punitive damages, the arbiters here exceeded their power.¹⁰⁹ Thus, the Second Circuit Court of Appeals reversed the portion of the judgment awarding the Plaintiffs punitive damages,¹¹⁰ and the remainder of the award was affirmed.¹¹¹ The court then directed the district court to enter judgment for the Plaintiffs in the amount of \$104,516 plus interest.¹¹²

V. COMMENT

The *Barbier* decision is important because it solidifies the law in regard to an arbiter's ability to award punitive damages where the parties' agreement is to resolve all disputes between them in accordance with the law of the state of New York. However, the New York approach frustrates the federal court system's policy goal of promoting settlement to avoid litigation. The shortcomings of the New York approach discourage arbitration and unfairly require parties to become intimately aware of the law of the state of New York to avoid the traps associated in choosing New York law to govern any dispute. The deficiencies of the New York approach as well as an alternative approach are discussed below.

The federal court system maintains a strong policy in favor of promoting settlement to avoid litigation.¹¹³ However, the approach that the federal courts in New York adopt, as illustrated in *Barbier*, conflicts with this goal.¹¹⁴ The New York approach frustrates settlement because it limits the parties' ability to

104. *Id.*

105. *Id.* (citing *Fahnestock*, 935 F.2d at 518).

106. *Id.* (citing *Fahnestock*, 935 F.2d at 518).

107. *Id.* at 123.

108. *Id.* at 122; see *Carte Blanche*, 888 F.2d at 264.

109. *Barbier*, 948 F.2d at 122.

110. *Id.* at 123.

111. *Id.*

112. *Id.*

113. See *supra* note 2 and accompanying text.

114. *Willoughby*, 598 F. Supp. at 364; see also *Kupperman & Freeman*, *supra* note 25, at 1597.

resolve all disputes in arbitration.¹¹⁵ For example, assume that a party brings both a contract and a tort action involving potential punitive damages arising under the parties' agreement.¹¹⁶ The contract claim may be arbitrated, whereas a tort claim involving punitive damages must be resolved by the court system.¹¹⁷ This result does not foster the policy goal of reducing congestion in the court system¹¹⁸ and does not allow arbitration to provide finality to disputes between the parties.¹¹⁹ Thus, the *Barbier* case discourages arbitration and fails to promote settlement to reduce litigation.

The New York approach also unfairly requires that the parties become intimately aware of the ramifications of incorporating New York law into their agreement. In *Barbier*, as in similar cases involving brokerage agreements, the brokerage firm provides the contract detailing the parties' relationship.¹²⁰ This contract will often contain a choice-of-law clause and a boilerplate arbitration clause.¹²¹ Often, these contracts are entered into by the brokerage firm's clients who are unaware of the consequences in choosing New York law to govern the agreement.¹²² Thus, a client may unknowingly relinquish his or her claim for punitive damages or at least may be barred from pursuing such claim in arbitration.¹²³

Where the parties believe that all of the disputes that arise between them will be resolved through arbitration, it frustrates the intent of the parties to disallow resolution of a punitive damages issue, especially when factored with the difficulty in understanding unsettled New York law.¹²⁴ Additionally, the result in *Barbier* is unfair because it is in conflict with traditional notions of waiver¹²⁵ and the contract doctrine of construing agreements against the drafter.¹²⁶ For the many reasons outlined above, the result in *Barbier* is unfair and discourages arbitration because it requires an intimate knowledge of the ramifications of incorporating the law of the state of New York into an agreement.

The better approach is to grant arbiters the flexibility to award punitive damages when parties have included a broad arbitration clause stating that all

115. *Willoughby*, 598 F. Supp. at 364; see also Kupperman & Freeman, *supra* note 25, at 1597.

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

117. *Id.* at 364.

118. *Id.*

119. *Id.*

120. Thomas J. Stipanowich, Note, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U. L. REV. 953, 1007-08 (1986).

121. See *id.* at 1008.

122. *Id.*

123. *Id.*; see also *Willoughby*, 598 F. Supp. at 364-65.

124. Stipanowich, *supra* note 120, at 1008-09; see also Thomas J. Kenny, Comment, *Punitive Damages in Securities Arbitration: The Unresolved Question of Pendent State Claims*, 37 CATH. U. L. REV. 1113, 1140-41 (1988).

125. Stipanowich, *supra* note 120, at 1008 (citing Cornelia G. Farmer, Comment, *Commercial Arbitration Agreements: Let the Signer Beware*, 61 MARQ. L. REV. 466, 479 n.74 (1978)).

126. *Id.* at 1009 (citing RESTATEMENT (SECOND) OF CONTRACTS § 84 (1982); SAMUEL WILLISTON, 11 WILLISTON ON CONTRACTS §§ 678-79 (Walter H.E. Jaeger ed., 3d ed. 1968)).

disputes between the parties arising out of a certain contract will be resolved in arbitration. An arbitrator's power to award punitive damages should only be restricted when the parties explicitly provide in their agreement that the arbitrator may not award such damages. This approach fosters a number of policy goals; specifically, it promotes settlement and deters malicious and outrageous conduct. This approach also eliminates claim-preclusion problems, issue preclusion problems, and preemption problems involved in the conflicts between state law and the FAA. Finally, uniform adoption of this approach would create stability in this area of law because the uncertainty involved in choosing the law of the state of New York would be eliminated. Thus, the parties would be aware of the ramifications of the agreement when they entered into it.

Unless explicitly stated otherwise, allowing an arbitrator the flexibility to award punitive damages fosters the policy goal of promoting settlement.¹²⁷ Under the law of the state of New York, parties who seek punitive damages are often forced to utilize arbitration for a portion of their claims and then move to the court system to pursue punitive damages.¹²⁸ Thus, the incentive for including an arbitration clause in the agreement, i.e., fast and non-judicial resolution of a dispute, is removed.¹²⁹

The strongest argument in opposition to allowing arbitrators to award punitive damages in all cases rests on the notion that punitive damages are granted to punish, a function preserved to the state through the court system.¹³⁰ However, arbitrators' awards are routinely approved by the court before the award becomes final and binding on the opposing party.¹³¹ Thus, the court system will have the opportunity to evaluate the reasonableness of any arbitral award of punitive damages.¹³² Therefore, the approach which allows an arbitrator to award punitive damages in all cases, unless explicitly precluded in the parties' agreement, should be adopted.

Allowing an arbitrator to award punitive damages also promotes the policy goal of punishing and deterring wrongful behavior.¹³³ Under New York law, a party

127. *Willoughby*, 598 F. Supp. at 363-64 (citing *Davis v. Chevy Chase Fin., Ltd.*, 667 F.2d 160, 164-65 (D.C. Cir. 1981)); see also *Ultracashmere House Ltd.*, 664 F.2d at 1179.

128. *Willoughby*, 598 F. Supp. at 364.

129. *Id.* (citing *Davis*, 667 F.2d at 164-65; *Ultracashmere House Ltd.*, 664 F.2d at 1179).

130. *Garrity*, 353 N.E.2d at 796-97.

131. See *Barbier*, 948 F.2d at 120.

132. Section 10 of the Arbitration Act states that an arbitrator's award may be vacated if (a) the award is a product of fraud; (b) there is evidence that the arbitrator is biased; (c) the arbitrator was guilty of misconduct which prejudiced one of the parties; or (d) the arbitrator exceeded their powers. *Kupperman & Freeman*, *supra* note 25, at 1609. Courts have also found that an arbitrator's award may be vacated if the arbitrator has manifestly disregarded the law, the award is arbitrary or capricious, or enforcement of the award would violate public policy. *Id.* The author of this Casenote notes that often presentation of an arbitration award is not broken down into amounts for punitive and other types of damages. To provide the parties and the court with the ability to determine the reasonableness of a punitive damages award, the amount allocated for punitive damages should be listed separately.

133. *GHIARDI & KIRCHER*, *supra* note 65, §§ 2.01-.09.

may breach an agreement and expect to pay the same amount in damages in arbitration regardless of the maliciousness of the breach. This immunity from punitive damages will encourage intentional wrongdoing.¹³⁴ Further, the party seeking punitive damages will have to bring an action in the court system which may deter a party from pursuing the claim.¹³⁵ Granting an arbiter the power to award punitive damages will remedy this problem because breaching parties who are aware that they are subject to punitive damages may be less likely to indulge in outrageous and malicious behavior. Because of its deterrent effect, an approach which allows arbiters to award punitive damages should be adopted in place of the current New York approach.

Adoption of an approach which would allow arbiters to award punitive damages would also eliminate litigation surrounding conflicts of state law preemption of the FAA. In *Volt Information Sciences v. Board of Trustees*,¹³⁶ the court reiterated the doctrine that parties should be able to arbitrate in any manner that they wish.¹³⁷ Thus, courts are faced with determining what the parties intended by incorporating a choice-of-law clause in their agreement.¹³⁸ The possibilities include: (1) the parties intended to incorporate state law and fully displace the FAA;¹³⁹ (2) the parties intended to adopt state substantive law only, whereby federal law would control procedure, validity and enforceability issues;¹⁴⁰ or (3) the parties intended to adopt state procedural rules but intended that federal substantive law should apply.¹⁴¹ Given the myriad of possibilities, a court would be able to use a choice-of-law clause to achieve any result it believes is practical.¹⁴² This situation creates uncertainty for the parties.¹⁴³ Uniform adoption of an approach which would provide arbiters with the power to award punitive damages would remove this uncertainty and would encourage parties to enter agreements to arbitrate because they would know the effect of the agreement before they enter into it. Encouraging parties to enter arbitration agreements fosters the federal policy of promoting settlement to discourage litigation.

134. Kenny, *supra* note 124, at 1140.

135. *Willoughby*, 598 F. Supp. at 364.

136. 489 U.S. 468.

137. See Arthur S. Feldman, Note, *Volt Information Sciences v. Board of Trustees of Leland Stanford Junior University: Confusing Federalism With Policy Under the FAA*, 69 TEX. L. REV. 691, 710 (1991).

138. *Id.*

139. *Id.* at 712.

140. *Id.* at 716.

141. *Id.* at 719.

142. *Id.*

143. *Id.*

VI. CONCLUSION

Promotion of settlement to reduce litigation is a well-established policy goal of our federal court system. Flexibility in fashioning remedies in alternative dispute resolution advances this policy goal. An approach which would allow punitive damages to be awarded in all cases (except where the parties expressly provide to the contrary) promotes settlement of disputes. Further, because such an approach does not require an in-depth understanding of state substantive law, it is fair to all parties. Such an approach would avoid problems of parties unwittingly waiving a claim to punitive damages or forcing a party to pursue the claim in arbitration as well as in the court system. Thus, adoption of a uniform rule which allows an arbiter to award punitive damages unless expressly precluded in the parties' agreement would promote settlement and preserve fairness to all parties.

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