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Exemplary Awards in Securities Arbitration: Short-Circuited Rights to Punitive Damages - Mastrobuono v. Shearson Lehman Hutton, Inc.

Isham R. Jones III

NOTES

Exemplary Awards in Securities Arbitration: Short-Circuited Rights to Punitive Damages

Mastrobuono v. Shearson Lehman Hutton, Inc.[1]

I. INTRODUCTION

Despite some residual image problems, arbitration is far from a modern day phenomenon.[2] Aristotle himself was a fan of arbitration, "for the arbitrator keeps equity in view, whereas the judge looks only to the law."[3] However, inconsistency among federal courts regarding the award of punitive damages by arbitrators has only furthered the image problem.[4] Discord among courts arises when parties sign a contract agreeing to be bound by the law of a state which prohibits arbitral awards of punitive damages along with contract language which seems to express intent to allow punitive damages.[5] Under the Federal Arbitration Act ("FAA"), federal courts may vacate arbitration awards that exceed the scope of the arbitrator's authority.[6] This only begs the question of what is the scope of an arbitrator's authority. In response to this issue, courts among the federal appellate judiciary have taken opposite views, awaiting guidance from the United States Supreme Court.[7]

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1. 20 F.3d 713 (7th Cir. 1994), *cert. granted*, 115 S.Ct. 1212 (1994). This case is currently pending before the United States Supreme Court. *See infra* ADDENDUM, for the Court's holding.

2. Constantine N. Katsoris, *Punitive Damages in Securities Arbitration: The Tower of Babel Revisited*, 18 FORDHAM URB. L.J. 573, 577 (1991).

3. *Id.* (citing THE SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, THE ARBITRATORS MANUAL (1989)).

4. J. Alexander Sec., Inc. v. Mendez, 114 S. Ct. 2182, 2183 (1994) (O'Connor, J., dissenting).

5. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jana, 835 F. Supp. 406, 412 n.7 (N.D. Ill. 1993).

6. 9 U.S.C. § 10(a)(4) (1992). Section 10(a)(4) of the Federal Arbitration Act states that a federal court may, upon application of a party to the arbitration, vacate an award "where the arbitrators exceeded their powers . . . ." *Id.*

7. *Mendez*, 114 S. Ct. at 2183 (O'Connor, J., dissenting).

II. FACTS AND HOLDING

In October of 1985, Nick DiMinico solicited Antonio and Diana Mastrobuono ("Mastrobuonos") to open a brokerage account with his firm, Shearson Lehman Hutton, Inc. ("Shearson").[8] Upon opening the account, a Client Agreement ("Agreement") was signed between the Mastrobuonos and Shearson.[9] The Agreement set forth that any controversy relating to the Mastrobuonos' account would be settled by arbitration and would be governed by New York law.[10]

Four years later, the Mastrobuonos claimed that DiMinico and Shearson had subjected their account to unauthorized trading,[11] churning,[12] and margin exposure.[13] The Mastrobuonos filed a complaint with the United States District Court for the Northern District of Illinois, Eastern Division, containing federal claims as well as state statutory and tort claims.[14] The Mastrobuonos requested punitive damages for the tort claims.[15] The District Court granted Shearson's motion to compel arbitration before the National Association of Securities Dealers ("NASD").[16] The Mastrobuonos retained their claim for punitive damages and filed an amended complaint in arbitration alleging violations of the NASD Rules of Fair Practice,[17] S.E.C. Rule 10b-5,[18] § 15(c)(1) of the Securities Exchange Act,[19] the Illinois Consumer Fraud Act,[20] the Texas Deceptive Trade

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

9. Mastrobuono v. Shearson Lehman Hutton, Inc., 812 F. Supp. 845, 846 (N.D. Ill. 1993).

10. *Id.* Paragraph 13 of the Agreement states, in relevant part:

> This agreement . . . shall be governed by the laws of the State of New York . . . . [A]ny controversy arising out of or relating to [the plaintiffs'] accounts . . . shall be settled by arbitration 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. and/or the American Stock Exchange, Inc. as [the plaintiffs] may elect . . . .

Mastrobuono, 20 F.3d at 715.

11. Unauthorized trading occurs when a broker purchases or sells stock on behalf of an investor who has not authorized the transaction. 1 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 10.10.1 (2d ed. 1990).

12. "Churning" occurs when a broker enters into transactions for the purpose of generating commissions or to make unjustifiable gains from the investor's loss or transaction costs. *Id.* at § 10.10. Churning is different from unauthorized trading in that a plaintiff attempts to show that the only purpose of the excessive trading is to generate fees. *Id.* Unlike an unauthorized trading claim, the plaintiff need not argue that the trading was per se unauthorized. *Id.* at § 10.11.

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

14. *Id.* at 715.

15. *Id.*

16. *Id.*

17. *Id.*

18. Rule 10b-5 of the Securities Exchange Act of 1934 is the Act's general anti fraud provision. *See* HAZEN, *supra* note 11, § 10.10. *See also* 17 C.F.R. § 240.10b-5 (1990).

19. Section 15(c)(1) of the Securities Exchange Act of 1934 states in part that "[n]o broker or dealer shall make use of the mails or any means . . . of interstate commerce to effect any transaction in . . . any security . . . otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device . . . ." 15 U.S.C. § 15(c)(1) (1988). The terms "manipulative, deceptive, or other fraudulent device" as used in § 15(c)(1) are defined by

Practices-Consumer Protection Act,[21] breach of fiduciary duty and negligence.[22]

A panel of three arbitrators held hearings on all claims in August and September of 1992.[23] On the last day of the hearings, Shearson filed a brief stating that the panel lacked authority to award punitive damages.[24] At the conclusion of the hearings, the Mastrobuonos were awarded $ 115,274.00 for wrongfully generated commissions and $ 44,053.00 for the margin interest.[25] In addition to these amounts, the panel also ordered Shearson and DiMinico to pay the Mastrobuonos $ 400,000.00 in punitive damages.[26] Shearson paid the compensatory damages but challenged the panel's authority to award punitive damages.[27]

Shearson filed a motion in federal district court to vacate the punitive damages award, arguing that the governing law of the Agreement, New York law, prohibits an arbitral award of punitive damages.[28] In response, the Mastrobuonos asked the district court to do one of three things; confirm the award, order a trial on the amount of punitive damages; or hold a separate trial on the punitive damages claims.[29] After a hearing, the district court denied the Mastrobuonos' motions and vacated the punitive damages award, relying on § 10(a)(4) of the FAA.[30]

The trial court based its decision on three factors.[31] First, the Mastrobuonos waived the possibility of a punitive damages award by signing the Agreement with Shearson.[32] In holding that the Agreement expressly adopted the laws of New York, the trial court followed a long line of authority stating that parties to an arbitration agreement governed by New York law waive any potential for punitive damages awards.[33] Second, the trial court rejected the Mastrobuonos' argument

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Rules 15cl-7(b) and 15cl-8 of the 1934 Act.

20. ILL. ANN. STAT. ch. 815, para. 505 (Smith-Hurd 1993).
21. TEX. BUS. & COM. CODE ANN. § 17.41 (West 1987).
22. *Mastrobuono*, 20 F.3d at 715.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. *Mastrobuono*, 812 F. Supp. at 846.
28. *Mastrobuono*, 20 F.3d at 715.
29. *Id.* at 715-16.
30. *Id.* at 716. *See supra* note 6 and accompanying text. Under this standard, any errors of law made by the arbitrator are normally unreviewable. Chicago Typographical Union No. 16 v. Chicago Sun-Times, Inc., 935 F.2d 1501 (7th Cir. 1991) (noted in *Mastrobuono*, 20 F.3d at 716). However, a court may reverse an award that was not clearly "within the contemplation of the parties and . . . implicitly authorized by the agreement." Miller Brewing Co. v. Brewery Workers Local Union No. 9, 739 F.2d 1159, 1164 (7th Cir. 1984)(noted in *Mastrobuono*, 20 F.3d at 716). Applying these standards to the case at bar, the court held that "[t]he District Court properly reviewed the panel's authority to award punitive damages." *Mastrobuono*, 20 F.3d at 716.
31. *Mastrobuono*, 812 F. Supp. at 847-48.
32. *Id.* at 848.
33. *Id.* at 847.

that the FAA preempts applying the state law rule which precludes punitive damages.[34] The court reasoned that the FAA does not create any independent rights to arbitrate and that upholding the choice-of-law provision of the contract is consistent with the goals of the FAA.[35] Third, the trial court did not find language in the Agreement, explicitly or by incorporation, authorizing the award of punitive damages.[36]

On appeal, the United States Court of Appeals for the Seventh Circuit agreed that the FAA promotes arbitration agreements, but it also found that the Mastrobuonos could not escape the choice-of-law provision contained in the Agreement.[37] Although the language of the Agreement incorporated the NASD Code of Arbitration Procedures,[38] this did not implicitly authorize an award of punitive damages in contradiction of the governing state law.[39] The court also held that when an agreement to arbitrate establishes a governing choice of law, and that law does not allow arbitrators to award punitive damages, the FAA will not preempt the state law and the potential for punitive damages will be waived.[40]

III. LEGAL HISTORY

As illustrated in *Mastrobuno*, a fiercely debated issue facing commercial arbitrators today is whether they may award punitive damages.[41] Courts have the option of confirming or vacating an award of punitive damages only after the aggrieved party challenges an arbitrator's authority to make such an award.[42] In the context of commercial arbitration,[43] a court may ask several questions before

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34. *Id.*

35. *Id.*

36. *Id.* at 848.

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

38. § 41(e) of the Code provides that arbitral awards "shall contain . . . a summary of . . . the damages and other relief awarded." *Id.* at 717.

39. *Id.*

40. *Id.* at 717-19.

41. Thomas J. Stipanowich, *Punitive Damages in Arbitration, Garrity v. Lyle Stuart, Inc., Revisited*, 66 B.U. L.REV. 953, 955 (1986). "Punitive damages are granted to punish malicious or willful and wanton conduct. The purpose of such an award is to deter the wrongdoer from similar conduct in the future as well as to deter others from engaging in such conduct." JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 14-3, at 589 (3d ed. 1984).

42. 9 U.S.C. § 9 (1988). The FAA provides that "after the arbitration award is made any party to the arbitration may apply to the court . . . for an order confirming the award." *Id.* Section 10 provides the authority for vacating arbitration awards. *See supra* note 6. A dispute between an investor and a broker finds its way to an arbitrator generally by means of the agreement executed when the account is opened. Katsoris, *supra* note 2, at 578.

43. Different concerns are present in other areas of arbitration. Raytheon Co. v. Automated Business Sys., Inc., 882 F.2d 6, 10 (1st Cir. 1989). For example, labor arbitration disfavors punitive awards because of the ongoing relationship between the parties. *Id.* An award of punitive damages may decrease parties confidence and commitment to arbitration. *Id.* In contrast, commercial arbitration "is normally considered a one-shot endeavor, in which the parties have chosen arbitration

deciding the fate of an exemplary award.[44] Courts may examine the specific language of the parties' contract and the rules of arbitration incorporated into the agreement for intent to authorize the award of punitive damages.[45] If the parties have included a choice-of-law provision, a court may consider that forum's policy in regard to awards of punitive damages by arbitrators.[46] In light of the current split of authority among the federal judiciary, an agreement choosing a forum which prohibits arbitral awards of punitive damages presents the most difficult question a court faces.[47] That question is whether to subscribe to one of the different positions taken by earlier courts or "decide according to equitable assessments while awaiting guidance from the United States Supreme Court."[48]

Upon deliberation of several or all of these factors, courts have taken three main approaches to the punitive damages issue.[49] Courts limiting the availability of punitive damages fall into two categories.[50] Some courts follow the rule established in *Garrity v. Lyle Stuart, Inc.*[51] prohibiting arbitral awards of punitive damages under all circumstances.[52] Other courts limit a commercial arbitrator's authority to award punitive damages by requiring explicit language to that effect in the parties' arbitration agreement.[53] Still other jurisdictions allow arbitral awards of punitive damages although the arbitration agreement contains no express mention of such relief.[54]

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not as a means of ongoing dispute resolution, but as a 'simpl[e], informal, and expeditio[us]' method of resolving a particular dispute." *Id.* at 10-11 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 628 (1985)).

44. *See* Katsoris, *supra* note 2, at 587-90.

45. *Id.* An agreement may be resolved by one of many Securities Regulatory Organizations ("SRO"), including the NASD and the New York Stock Exchange. *Id.* at 580. These different organizations have appointed representatives to the Securities Industry Conference on Arbitration ("Conference"), a task force created to achieve uniformity and consistency in securities arbitration. *Id.* at 581. A chief goal of the Conference has been to improve the image of arbitration "as a speedy, economic and fair method for the resolution of securities disputes." *Id.* Although not an SRO, the American Arbitration Association also enjoys popularity among securities arbitrators. *See Id.* at 584.

46. *See Id.* at 587-90.

47. *Mendez*, 114 S. Ct. at 2182-83 (O'Connor, J., dissenting).

48. Katsoris, *supra* note 2, at 590-91.

49. *Raytheon*, 882 F.2d at 11; *see also*, Kelley v. Michaels, 830 F. Supp. 577, 579 (D. Colo. 1993).

50. *Raytheon*, 882 F.2d. at 11.

51. 353 N.E.2d 793 (N.Y. 1976).

52. *Raytheon*, 882 F.2d at 11. The *Garrity* decision is the most often cited case standing for this proposition. The *Raytheon* court lists several jurisdictions that have followed the lead of the *Garrity* rule holding that even express consent of the parties could not confer authority to award punitive damages in purely private disputes. *Id.*

53. *Id.* An intermediate state court in California took this position in Belko v. AVX Corp., 251 Cal. Rptr. 557 (Cal. Ct. App. 1988). For a contrary treatment of the punitive damages issue by a different California appellate court, see *infra* note 122 and accompanying text.

54. *Raytheon*, 882 F.2d at 11.

A. Restraining Arbitral Punitive Damages Awards

Courts limiting an arbitrator's authority to award punitive damages have done so on several grounds. Many brokers include a forum selection clause in their customer agreements providing, for example, that the "agreement . . . shall be governed by the laws of the State of New York."[55] New York is an important state in this regard for two reasons. First, the substantive law of New York permits courts to award punitive damages under certain circumstances.[56] However, the arbitration law of New York does not permit an arbitrator to award punitive damages under any circumstances.[57] New York arbitration law is also important because many brokers specify New York in forum selection clauses.[58]

In *Garrity*, the New York Court of Appeals struck down an award by a commercial arbitration panel, holding that "[a]n arbitrator has no power to award punitive damages, even if agreed upon by the parties."[59] In doing so, the court relied on the strong public policy that punitive damages remain a sanction reserved to the state and that parties could not submit themselves to punishment directly or through arbitration.[60] Courts have taken this rationale, along with a choice-of-law provision specifying New York law, and held arbitral awards of

55. 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 Attorneys' Fees and Costs*, 65 TUL. L. REV. 1547, 1599 (1991).

56. *Id.* In New York, punitive damages are available when a defendant has engaged in willful and wanton misconduct. *Id.*

57. *Id.* at 1600.

58. *Mendez*, 114 S. Ct. at 2183 (O'Connor, J., dissenting) ("most securities agreements contain arbitration provisions, and many are governed by New York law."). *See also* Katsoris, *supra* note 2 ("many arbitration agreements contain a New York choice-of-law clause.").

59. *Garrity*, 40 N.Y.2d at 356, 353 N.E.2d at 794, 386 N.Y.S.2d at 832.

60. *Id.* In his article, Stipanowich noted the concern of the majority in *Garrity* "regarding the displacement of the courts as arbiters of social justice . . . by the perceived absence of standards for judicial oversight of arbitrators' awards." Stipanowich, *supra* note 41, at 961. He also explained that the court feared "oppressive misuse of arbitral power" and that arbitration "would become little more than a trap for the unwary, with unpredictable results, eroding confidence in its use and ultimately destroying its value." *Id.* at 962.

punitive damages unenforceable.[61] This reasoning has enjoyed approval and support from other state courts as well as federal courts.[62]

Courts which limit an arbitrator's remedial powers begin their discussion of punitive damages with the applicability of the *Garrity* rule.[63] Although not all courts treat it as such, the availability of punitive damages is a preemption issue, turning on whether New York law or federal substantive arbitration law governs.[64] In *Fahnestock & Co. v. Waltman*,[65] the Second Circuit faced this issue and concluded that the FAA did not preempt the *Garrity* rule.[66] To support this position, the *Fahnestock* court pointed to the United States Supreme Court's decision in *Volt Info. Sciences v. Board of Trustees of the Leland Stanford Jr., Univ.*[67] The Supreme Court in *Volt* found that "[t]he FAA contains no specific preemption provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."[68] In this regard, state law is only preempted by the FAA

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61. "The [*Garrity*] rule maintains its vitality in the courts of New York." Fahnestock & Co. v. Waltman, 935 F.2d 512, 517 (2d Cir. 1991). *See also* Barbier v. Shearson Lehman Hutton, Inc., 948 F.2d 117, 122 (2d Cir. 1991). *Garrity* also stands for the proposition that an agreement to arbitrate disputes under New York law acts as a waiver of the right to exemplary relief in any form. Stipanowich, *supra* note 41, at 963.

In *Pierson v. Dean Witter, Reynolds, Inc.*, the Seventh Circuit reversed the lower court's determination that the investors had not waived their right to punitive damages as a result of the *Garrity* rule. The lower court judge found that "[the investors] did not specifically agree to waive their right to full legal remedy, including punitive damages" and refused to "thrust that harsh result upon them." *Pierson*, 742 F.2d at 337 n.4. On appeal, however, the Seventh Circuit reasoned that the investors could not "use their failure to inquire about the ramifications of [the choice-of-law] clause to avoid the consequences of agreed-to arbitration." *Id.* at 339.

62. Shaw v. Kuhnel & Assocs., Inc., 698 P.2d 880, 882 (N.M. 1985); Baselski v. Paine Webber, Jackson & Curtis, Inc., 514 F. Supp. 535, 543 (N.D. Ill. 1981). *Garrity* finds it's strongest support in two decisions from the Second Circuit. *Barbier*, 948 F.2d 117 at 121; *Fahnestock*, 935 F.2d 512 at 517. *See infra* notes 65-87 and accompanying text.

63. Merrill Lynch, Pierce, Fenner & Smith v. Jana, 835 F. Supp. 406, 411 (N.D. Ill. 1993); *Barbier*, 948 F.2d at 121; *Fahnestock*, 935 F.2d at 517.

64. *Jana*, 835 F. Supp. at 412; *see also Barbier*, 948 F.2d at 122; *Fahnestock*, 935 F.2d at 518. "The effect of the [FAA] is to create a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

65. 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 502 U.S. 942 (1992).

66. *Id.* at 517.

67. 489 U.S. 468 (1989); *Fahnestock*, 935 F.2d at 517.

68. *Volt*, 489 U.S. at 477, *cited in Fahnestock*, 935 F.2d at 517. In regard to federal preemption, the Supreme Court found that "[t]he body of preemptive federal substantive law that supports the FAA . . . developed largely in response to state laws that restrict arbitration in derogation of agreements freely negotiated." *Id.* at 518.

when it actually conflicts with federal law.[69] In *Fahnestock*, the court concluded that no such conflict existed between the FAA and the *Garrity* rule.[70]

In *Barbier v. Shearson Lehman Hutton, Inc.*,[71] the Second Circuit reversed the trial court's confirmation of an arbitral award of punitive damages.[72] Relying on the earlier *Fahnestock* decision, the court determined that the FAA only required enforcement of the parties' agreement to arbitrate, not the preemption of federal arbitration law over state law.[73] Therefore, the court's decision to apply the *Garrity* rule under the choice-of-law clause specifying New York law merely enforced the parties' agreement, which is "fully consistent with the goals of the FAA."[74]

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69. *Id.* However, the *Fahnestock* court noted that if the parties had specifically agreed to permit the arbitrators to award punitive damages, "federal arbitration law might require confirmation." *Id.* In *Volt*, the Supreme Court stated that parties are free to fashion their own arbitration agreements and the FAA would require enforcement of such an agreement. *Id.* In *Barbier*, the Second Circuit again cited *Volt* to enforce provisions of an arbitration clause contained in a securities agreement. *Barbier*, 948 F.2d at 122. *See also infra* notes 71-74 and accompanying text.

70. *Volt*, 489 U.S. at 517. The *Fahnestock* court conceded that the *Garrity* rule runs against the grain of federal arbitration law and emphasized that specific language on the punitive damages issue may have negated application of the *Garrity* rule. *Id.* at 518. In addition, the court left open the possibility that another arbitration organization may provide language authorizing punitive awards by restricting their ruling to the language of the New York Stock Exchange Constitution and rules. *Id. See also infra* notes 84-87 and accompanying text.

Judge Mahoney dissented in *Fahnestock* and noted that the majority analysis created an unnecessary split among the circuits. *Volt*, 489 U.S. at 520. First, the dissent found the majority's application of the *Garrity* rule inappropriate and that federal law should have provided the rules of decision. *Id.* For support, the dissent also cited the Supreme Court in *Volt*, finding that state law restricting the right to arbitrate disputes in accordance with an agreement conflicts with the FAA and is preempted thereby. *Id.* For further support, Judge Mahoney pointed to other circuits which do not automatically subject agreements to the *Garrity* rule because the forum selection clause specifies New York law. *Id.* at 521.

71. 948 F.2d 117 (2d Cir. 1991).

72. *Id.* at 123. The trial court "recognized that the FAA does not preempt the application of all state laws, especially where the parties have provided in their agreement for the application of state laws." *Id.* at 119. *See also Barbier*, 752 F. Supp. at 155. However, the lower court refused to bind the parties to the *Garrity* rule simply because the choice-of-law clause specified New York law. *Barbier*, 948 F.2d at 120. Instead, the court distinguished between New York substantive law and New York arbitration law. *Id.* After concluding that the *Garrity* rule is arbitration law, the court stated that "the parties did not intend . . . that New York arbitration law be applied to disputes under the Agreement." *Id.* The Second Circuit, however, did not agree and reasoned that a policy based foundation underlying the *Garrity* rule did not render it any less a rule of substantive law. *Id.* at 122.

73. *Id. See also supra* note 68.

74. *Barbier*, 948 F.2d at 122. The court determined that the agreement should be enforced according to it's terms, "even if the result is that punitive damages are prohibited where in the absence of the choice-of-law provision, they would be permitted." *Id.*

The *Jana* court cited the Second Circuit decisions in *Fahnestock* and *Barbier* as persuasive authority that the *Garrity* rule is not preempted by federal law. *Jana*, 835 F. Supp. at 413. Although the parties agreed that "[the] case is governed by the law of New York to the extent that it is not preempted by the FAA," the court concluded that New York law governed both the interpretation and the enforcement of the agreement. *Id.* at 408. Determining the rights of the parties according to New York law merely enforced the terms of the contract. *Id.* at 413.

Closely related to the issue of preemption, courts also consider the parties' basis for jurisdiction when determining the availability of punitive damages.[75] In *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,[76] the United States Supreme Court found that although the FAA "creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate, . . . it does not create any independent federal question jurisdiction."[77] Therefore, as the court in *Fahnestock* observed, the parties invoked diversity jurisdiction as a means of acquiring subject matter jurisdiction.[78] In *Fahnestock*, the court explained that since jurisdiction is based on diversity, state law is not preempted by federal law and should govern the availability of punitive damages.[79] By reaching this conclusion, the court cleared the way for application of the *Garrity* rule, prohibiting arbitral award of punitive damages.[80]

Another basis advanced by courts limiting punitive damage awards involves judicial interpretation of whether the agreement language itself authorizes arbitrators to make exemplary awards.[81] A typical arbitration clause will specify that all arbitration will be conducted pursuant to the rules of one of many securities organizations, such as the New York Stock Exchange ("NYSE"), the NASD, or the American Arbitration Association ("AAA").[82] Upon election of an organization by the parties, the arbitration rules of that organization are then incorporated into the agreement to govern all arbitration.[83]

In *Fahnestock*, the Second Circuit examined the language of the NYSE constitution and rules of arbitration for language concerning the issue of punitive damages.[84] Despite containing broad language, the court found the NYSE provisions silent regarding the scope of potential remedies and the issue of

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75. *See generally Barbier*, 948 F.2d at 121; *Fahnestock*, 935 F.2d at 518.

76. 460 U.S. 1 (1983).

77. *Moses H. Cone Mem. Hosp.*, 460 U.S. at 25 n.32.

78. *Fahnestock*, 935 F.2d at 518. The requirements of diversity jurisdiction are set out in 28 U.S.C. § 1332 (1993).

79. *Fahenstock*, 935 F.2d at 519. The court reached this conclusion by finding that "state law relating to the propriety of a punitive damages award by arbitrators in the absence of an agreement on the subject is not preempted by any federal substantive law bearing on the subject." *Id.*

80. *Id.*

81. *See generally Jana*, 835 F. Supp. at 411; *Fahnestock*, 935 F.2d at 521.

82. *Jana*, 835 F. Supp. at 408; *Barbier*, 948 F.2d at 119; Pierson v. Dean, Witter, Reynolds, Inc., 742 F.2d 334, 336 (7th Cir. 1984). The typical agreement provides that "[a]ny controversy between [investor] and [broker] arising out of or relating to this contract . . . shall be settled by arbitration, in accordance with the rules . . . of either the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as the [investor] may elect." *Id.* at 336.

83. *Jana*, 835 F. Supp. at 409. "Having chosen to arbitrate this case with the NASD, the Janas have chosen that the case be governed by the NASD Code as well." *Id. See also Fahnestock*, 935 F.2d at 518.

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

punitive damages.[85] In the eyes of the court, failure to include within the agreement specific language or arbitration rules expressly authorizing arbitrators to award punitive damages foreclosed the option of making such an award.[86] "Clearly, if the NYSE wanted to empower arbitrators to award punitive damages, it could have done so."[87]

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jana*,[88] the District Court for the Northern District of Illinois stayed arbitration proceedings to determine if the parties' agreement authorized arbitral awards of punitive damages.[89] Upon searching the agreement, the court concluded that no such authorization was given.[90] The arbitration clause incorporated the NASD Code of Arbitration Procedures ("Code") which, the court found, makes no specific provision for punitive damages.[91] The investors argued that the language of the Arbitrator's Manual ("Mannual")[92] specifically stated that arbitrators may consider punitive damages as a remedy.[93] The relevant portion of the Manual provides that "[t]he issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy."[94] However, the court rejected this argument because only the Code was incorporated into the agreement, not the Manual.[95] Had the Manual or other specific language authorizing punitive damages been part of the parties' agreement,

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85. *Id.* The NYSE Constitution provides that "[a]ny controversy between . . . a member . . . and any other person, arising out of the business of such member . . . , shall at the instance of any such party, be submitted for arbitration . . . ." *Id.* at 518. In addition, NYSE rule 600(a) provides for the arbitration of "[a]ny dispute, claim or controversy." *Id.* at 519.

To support a claim that the arbitrators were empowered to award punitive damages, the investor in *Fahnestock* pointed to the NYSE award form which contains a specific heading marked "punitive damages" allowing for the entrance of such awards. *Id.* However, the court found that the award form was not part of the arbitration agreement and that the *Garrity* rule still required vacatur of the award. *Id.*

Judge Mahoney's dissent in *Fahnestock* also disagreed with the majority's interpretation of the NYSE language. *Id.* at 521. The dissent considered the award form relevant in determining the availability of punitive damages and found that it provided evidence of intent to authorize punitive damages. *Id.* To conclude, Judge Mahoney reasoned that "a much more hospitable approach to arbitral power to award punitive damages is appropriate . . . [g]iven the rule that ambiguities [are to be] resolved in favor of arbitration." *Id.* at 521.

86. *Id.* at 519. The court's reading and interpretation of the NYSE provisions was later cited with approval in *Barbier*. In contrast, the court noted that had the agreement incorporated the rules of the AAA, a different result may have ensued. The AAA rules provide that arbitrators may award "any remedy or relief which [is] just and equitable and within the scope of the agreement." *Id.*

87. *Id.*

88. 835 F. Supp. 406 (N.D. Ill. 1993).

89. *Id.* at 414.

90. *Id.* at 412.

91. *Id.*

92. The Manual was compiled by the Securities Industry Conference on Arbitration. *Id.* at 412. *See also supra* note 45.

93. *Jana*, 835 F. Supp. at 412.

94. *Id.*

95. *Id.*

the court noted that this may have required preemption over New York law prohibiting arbitral punitive damages awards.[96]

B. Support for Arbitral Punitive Damages Awards

The analysis used by courts allowing arbitral awards of punitive damages is much the same as those that do not. They begin by examining the agreement language and incorporated arbitration rules for evidence of the parties' intent to include punitive damages within the scope of potential remedies.[97] If the arbitration clause can be interpreted to authorize punitive damages, the next step is to consider the forum selection clause, if one is included.[98] Finally, a court must determine if federal law or state law is to govern the agreement.[99]

The most prominent federal case upholding an arbitral award of punitive damages is the Eleventh Circuit's decision in *Bonar v. Dean Witter Reynolds, Inc.*[100] The *Bonar* court began by analyzing the parties' agreement and discovered that the AAA Commercial Arbitration Rules ("AAA Rules") were incorporated into the arbitration clause.[101] The court found the agreement "far from a model of clarity on the subject of punitive damages"[102] because a close review revealed that the AAA Rules do not explicitly mention punitive damages.[103] In concluding that the investors did not intend to waive their right to punitive damages simply by signing such a vague agreement, the court followed federal policy mandating resolution of ambiguities in favor of arbitration.[104]

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96. *Id.* The court explained the predicament it faced by stating that "a conclusion that the quoted language was part of the parties' contract would require the Court to choose between conflicting terms within the customer agreement. One term, the incorporation of the NASD Rules, would permit punitive damages; another term, the incorporation of New York law, would prohibit them." *Id.*

97. Raytheon Co. v. Automated Business Sys., Inc., 882 F.2d 6, 9 (1st Cir. 1989).

98. *Id.* at 11.

99. *Id.*

100. 835 F.2d 1378 (11th Cir. 1988). *See also* Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 709 (7th Cir. 1994); Lee v. Chica, 983 F.2d 883, 887 (8th Cir. 1993); J. Alexander Sec., Inc. v. Mendez, 17 Cal. App. 4th 1083, 1090, 21 Cal. Rptr. 2d 826, 830 (Cal. Ct. App. 1993); Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1063 (9th Cir. 1991); Pyle v. Sec. U.S.A., Inc., 758 F. Supp. 638, 640 (D. Colo. 1991).

101. *Bonar*, 835 F.2d at 1386.

102. *Id.* at 1388.

103. *Id.* Section 42 (currently Section 43) of the AAA Commercial Arbitration Rules states that "[t]he arbitrator may grant any remedy or relief which he deems just and equitable and within the scope of the agreement." *Id.* at 1386. *See supra* note 86 and accompanying text.

104. *Bonar*, 835 F.2d at 1387-88. This policy was first enunciated by the U.S. Supreme Court in *Moses H. Cone Mem. Hosp.* and later followed by *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). "*Willoughby* tells us that in light of the federal policy that 'any doubts concerning the scope of arbitral issues should be resolved in favor of arbitration,' we must give precedence to the contract provisions allowing for punitive damages." *Bonar*, 835 F.2d at 1387. The *Bonar* court, by interpreting the AAA Rules in this manner, implies that only an express exclusion of punitive damages in the agreement would deprive arbitrators of authority to make such an award. *Id.* at 1388. In contrast, courts which limit arbitral

After determining the language of the AAA Rules sufficiently broad to authorize an arbitral award of punitive damages, the court turned to the choice-of-law provision, specifying New York law, to ascertain whether it's inclusion rendered punitive damages no longer within the scope of the parties' agreement.[105]

The court concluded that the choice-of-law provision did not have the above effect.[106] Although the *Garrity* rule would have applied under New York law, the FAA governed the agreement and such a provision in a contract subject to the FAA does not prevent arbitrators from awarding punitive damages.[107] To reach this conclusion, the court found the parties' agreement "evidenced a transaction in interstate commerce"[108] and that the *Garrity* rule "deal[s] only with the powers of arbitrators under state law and state public policy, and has no application in cases arising under the Arbitration Act."[109] Thus, the court determined that a

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awards of punitive damages require an express agreement in order to empower arbitrators to award punitive damages. *See supra* notes 85-96 and accompanying text.

105. *Bonar*, 835 F.2d at 1386-87. By reading the language of the AAA Rules to include punitive damages within the scope of potential relief, the *Bonar* court followed the interpretation given to similar contract language by the *Willoughby* court. *Id.* at 1387.

Although receiving favorable treatment by sister circuits, the majority's decision in *Bonar* was not unanimous. In a special concurrence, Circuit Judge Tjoflat agreed that, under circuit precedent, the arbitrator was not precluded from awarding punitive damages. *Id.* at 1388. However, he failed to see "how punitive damages can ever be considered 'within the scope of the agreement of the parties' absent some express provision in the contract." *Id.* Focusing on the contractual nature of the parties' agreement, Judge Tjoflat found it doubtful that the scope of relief in a contract dispute could "fairly be said to encompass the assessment of a penalty for willful or wanton misconduct." *Id.* at 1389. He stated that the AAA rules recognized this important distinction by limiting the available remedies to those within the scope of the parties' agreement. *Id.* He concluded that the majority's "adherence to a different rule reflects a basic misunderstanding of the nature of punitive damages and the scope of arbitrators' remedial powers." *Id.*

106. *Id.* at 1387.

107. *Id.*

108. *Id.*

109. *Id.* The Eleventh Circuit found support for this position in *Willoughby*. After considering the foundation and rationale used in *Garrity*, the *Willoughby* court rejected the public policy arguments supporting the *Garrity* rule and concluded that "there is no public policy bar which prevents arbitrators from considering claims for punitive damages." *Willoughby*, 598 F. Supp. at 361. Another district court also came to this conclusion a year before *Willoughby* was decided. Willis v. Shearson/American Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983). The *Willis* court "perceive[d] no public policy reason persuasive enough to justify prohibiting arbitrators from resolving issues of punitive damages submitted by the parties." *Id.* at 824.

Many courts have employed an "interstate commerce" analysis to determine whether federal law or state law will govern an agreement. Under Section 2, the FAA governs any "contract evidencing a transaction involving [interstate] commerce." 9 U.S.C. § 2 (1988). The *Willoughby* court also concluded that the parties' contract "evidence[ed] a transaction in interstate commerce" and that federal policy favoring arbitration governed the agreement. *Willoughby*, 598 F. Supp. at 359. In *Willis*, the court stated that "before the [FAA] becomes applicable, . . . the court must be satisfied that . . . the contract containing the arbitration provision evidences a transaction involving interstate commerce." *Willis*, 569 F. Supp. at 823. Subsequently, the *Willis* court found that "the interstate character of the contract is evident [because] [t]his is a diversity action between a resident plaintiff and a foreign securities broker." *Id.* The Eighth Circuit also recently affirmed this rationale in Lee v. Chica, 983 F.2d 883 (8th Cir. 1993). "Arbitrability of contracts evidencing interstate commerce is governed by

choice-of-law clause merely designates the substantive law to be applied in determining whether the conduct of the parties warrants an exemplary award, "it does not deprive the arbitrators of their authority to award punitive damages."[110]

The First Circuit, in *Raytheon Co. v. Automated Business Systems, Inc.*,[111] confirmed an arbitral award of punitive damages and based it's decision on the rationale espoused in *Bonar*.[112] After determining that the FAA governed the parties' agreement due to its interstate character, the court followed the *Bonar* court's interpretation of the AAA language and found sufficient authority to award punitive damages.[113] In addition, the *Raytheon* court offered a policy rationale in favor of allowing exemplary awards in arbitration.[114] The court failed to find a compelling reason to prohibit arbitrators from awarding punitive damages if the same conduct would give rise to such an award if proved to a court.[115] "Certainly, the fact that the parties agreed to resolve their dispute through an expedited and less formal procedure does not mean that they should be required to surrender a legitimate claim to damages."[116]

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federal law rather than state law." *Id.* at 886.

110. *Bonar*, 835 F.2d at 1387 (citing *Willoughby*, 598 F. Supp. at 359). The *Willis* court also found that "even assuming New York law applies, federal law governs the categories of claims subject to arbitration . . . [and] . . . [i]f an issue is arbitrable under federal law, it remains so despite contrary state law." *Willis*, 569 F. Supp. at 823-24.

111. 882 F.2d 6 (1st Cir. 1989).

112. *Id.* at 11. Although not a case concerning securities, the *Raytheon* court employed the case law on commercial arbitration, adopting the view that "the contract's choice-of-law provision does not require us to determine the punitive damages question by looking to the law of the chosen forum . . . Rather, we look to federal common law for our answer." *Id.* n.5.

113. *Id.* at 11-12. The *Raytheon* court agreed with other courts "that both the parties' adoption of AAA . . . Rule 42 . . . and the general canon that federal law governs the construction of arbitration agreements respecting interstate commerce" support the conclusion that the arbitrators were empowered to award punitive damages. *Id.* at 11 n.5.

Another commercial arbitration case, the Ninth Circuit's opinion in Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056 (9th Cir. 1991), also chose the "expansive view" taken by *Bonar* and *Raytheon* in regard to the language of the AAA Commercial Arbitration Rules. *Id.* at 1063. The *Cunard* court also relied on the Supreme Court's opinion in *Volt* to conclude that choosing New York law to govern the agreement did not preclude punitive damages. *Id.* at 1062.

The Eighth Circuit, in Lee v. Chica, 983 F.2d 883 (8th Cir. 1993), *cert. denied*, 114 S.Ct. 287 (1993), recently pointed to the decisions in *Bonar*, *Raytheon*, and *Cunard* as authority for allowing an arbitral award of punitive damages under the language of the AAA. *Id.* at 888. The *Lee* court noted that Minnesota, the governing law of the parties' agreement, had adopted the Uniform Arbitration Act and held that their conclusion would have been the same if they were to apply the UAA instead of the FAA due to the similarities between the two. *Id.* The liberal construction of the AAA language was not unanimous, however. Judge Beam, writing in dissent, failed to find authority to award punitive damages in the language of AAA Rule 43. *Id.* at 889.

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

115. *Id.* Like other courts around the nation, the *Raytheon* court agreed that "punitive damages can serve as an effective deterrent to malicious or fraudulent conduct." *Id.* at 12.

116. *Id.* The *Willoughby* court also supported this position by finding that a waiver of the right to punitive damages "not only would . . . seriously undermine the value and sufficiency of the arbitral process as a method of dispute resolution, it would also constitute a total frustration of the public policies and purposes served by punitive damage awards." *Willoughby*, 598 F. Supp. at 363.

Most recently, the Seventh Circuit, in *Baravati v. Josephthal, Lyon & Ross, Inc.*,[117] confirmed an arbitral award of punitive damages.[118] Writing for the court, Chief Judge Richard Posner realized that where diversity is the basis for federal jurisdiction, "substantial constitutional questions would arise if the federal courts tried to create a body of substantive law to be applied by the arbitrators."[119] Although the FAA is limited to diversity cases affecting interstate commerce, federal courts are free to create a body of substantive law applicable to cases falling within the scope of the act.[120]

Baravati is also important because the court interpreted the language of the parties' agreement, which incorporated the NASD Code, to embrace punitive damages within the scope of potential relief.[121] The court did not find specific authority to award punitive damages in the NASD Code, but did not conclude that silence on the issue prohibited such authority "given the tradition of allowing arbitrators flexible remedial discretion."[122] Other courts interpreting the NASD Code language have adopted an expansive view and allowed punitive damages to be awarded where the agreement incorporates the NASD Code.[123]

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117. 28 F.3d 704 (7th Cir. 1994).

118. *Id.* at 711.

119. *Id.* at 707. Judge Posner discussed that the conferral of diversity jurisdiction on federal courts by Article III of the U.S. Constitution "d[id] not authorize them to create substantive law to govern disputes arising under that jurisdiction." *Id.* (citing Erie R.R. v. Tompkins, 304 U.S. 64 (1938)).

120. *Id.* Judge Posner found authority for this position in two U.S. Supreme Court decisions, Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983), and Southland Corp. v. Keating, 465 U.S. 1 (1984).

121. *Baravati*, 28 F.3d at 709.

122. *Id.* at 710. A California appellate court refused to conclude that the "NASD's failure to specifically address the issue of punitive damages in its arbitration rules manual expressly precluded the arbitrators . . . from awarding punitive damages." J. Alexander Sec., Inc. v. Mendez, 17 Cal. App. 4th 1083, 1092, 21 Cal. Rptr. 2d 826, 831 (Cal. Ct. App. 1993), *reh'g and reh'g en banc denied, cert. denied*, 114 S. Ct. 2182 (1993). The *Mendez* court rejected the argument that the agreement did not contemplate punitive damages simply because the arbitration was conducted pursuant to NASD rules and not those of the AAA. *Id.*

123. Focusing on the language of the NASD Code § 1, which provides for the parties to arbitrate "any dispute, claim or controversy arising out of or in connection with the business of any member of the Association," two district courts have found authority for arbitral punitive damages awards under the NASD Code. *Pyle*, 758 F. Supp. at 640 ("I concluded that 'any dispute, claim or controversy' includes a claim for punitive damages."). In Kelley v. Michaels, 830 F. Supp. 577 (N.D. Okl. 1993), the court determined that "the expansive view of an arbiters' power to decide disputes, coupled with the incorporation of the NASD Code of Arbitration Rules in the parties' agreement, provide[d] the arbitration panel with the authority to award punitive damages." *Id.* at 580.

IV. INSTANT DECISION

In *Mastrobuono*, the Seventh Circuit faced an arbitral award of punitive damages.[124] After determining the proper scope of review, the court began it's discussion by applying the *Garrity* rule.[125] The court then turned to the language of the NASD Code and determined that it did not grant the arbitration panel authority to award punitive damages.[126] Third, the court determined that a preemption analysis was unnecessary because the parties adopted the *Garrity* rule as the law of the Agreement.[127] Finally, the court concluded that Illinois arbitration law did not govern the Agreement as a result of New York's law of conflicts.[128]

First, the court observed that a narrow scope of review applied but found that this did not immunize an award that clearly exceeded the bounds of the Agreement.[129] Relying on the Second Circuit's decision in *Barbier*, the court concluded that it is manifest that the arbitration panel exceeded their power by awarding punitive damages.[130] To reach this conclusion, the court stated that since the parties specified New York law without excluding its arbitration law, the *Garrity* rule was adopted as the binding rule of the Agreement.[131] The Mastrobuonos argued that the *Garrity* rule was inapplicable because the Agreement failed to expressly prohibit punitive awards.[132] The court dispensed with this argument by stating that specific exclusions must be written into the Agreement because no other source could provide them.[133]

Next, the court considered the Mastrobuono's argument that the NASD Code of Arbitration Procedures and the Arbitrator's Manual expressly authorized an

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124. *Mastrobuono*, 20 F.3d 715.

125. *Id.* at 716-17.

126. *Id.* at 717.

127. *Id.* at 719.

128. *Id.*

129. *Id.* at 716. For support, the court pointed to the language of an earlier Seventh Circuit decision, stating that a "court may reverse [an] award that 'clearly' was not 'within the contemplation of the parties and . . . implicitly authorized by the agreement.'" *Id.* (citing Miller Brewing Co. v. Brewery Workers Local Union No. 9, 739 F.2d 1159, 1164 (7th Cir. 1984)).

130. *Id.* Although the court recognized that "[t]he arbitrator's errors of law and contract construction are normally unreviewable," the court found that "our narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement." *Id.* at 716.

131. *Id.* at 717. The court pointed to another Seventh Circuit case where the factual situation was similar. *Id.* In that case, the investors were not allowed to recover punitive damages and could not use their ignorance of New York arbitration law to escape the consequences of their agreement. *Id.* (citing *Pierson*, 742 F.2d at 334). However, the *Pierson* court "did not address the argument that some other provision of the agreement authorized punitive damages, contra the choice of New York law." *Id.* at 717.

132. *Id.* The Mastrobuonos argued that the language "any controversy arising out of or relating to [the Mastrobuono's account] shall be settled by arbitration" included a claim for punitive damages. *Id.*

133. *Id.*

arbitral award of punitive damages.[134] The Agreement offered the Mastrobuonos a choice of organizations to conduct the arbitration hearing.[135] Since the NASD was chosen, the court concluded that neither the NASD Code nor the Manual grants a substantive right to punitive damages because this would directly conflict with the governing law of the Agreement.[136] Even if the NYSE rules were chosen to govern the arbitration, punitive damages would not have been within the scope of potential remedies.[137] The court reasoned that the parties did not intend for the availability to punitive damages to depend on which organization's rules were chosen and found "[t]he more sensible construction of the agreement is that the *Garrity* rule always controls."[138]

The third basis for the court's decision rested upon interpretation of federal policy.[139] The Mastrobuonos urged that federal policy requires arbitration be favored in any conflicts between the NASD and New York law.[140] Although conceding federal policy that doubts concerning the scope of arbitrable issues be resolved in favor of arbitration, the court found that this policy does not encompass the availability of exemplary awards.[141]

When determining the availability of punitive remedies, the court concluded that the federal policy in favor of arbitration is not as persuasive.[142] Although the agreement to arbitrate disputes must be liberally construed, this does not mean that all remedies are to be made available in arbitration.[143] The court recognized that other circuit courts have reached a different result, but decided to resolve any conflict between New York law and the NASD rules in favor of New York law.[144] Because the court concluded that the parties intended for *Garrity* to be the binding rule, it found that enforcing the state rule did not offend the policies espoused in the FAA.[145]

Finally, the court determined that the New York's law of conflicts did not direct the application of Illinois law rather than New York law.[146] Illinois' law of conflicts allows the parties' chosen law to apply unless it is strongly contrary

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134. *Id.* Section 41(e) of the Code provides that arbitral awards "shall contain . . . a summary of . . . the damages and other relief awarded." *Id. See also supra* note 92 and accompanying text.

135. *Id.* at 715. *See supra* note 10.

136. *Id.* at 717.

137. *Id.* The court determined that "the arbitration rules of the NYSE . . . do not empower arbitrators to award punitive damages." *Id.* This interpretation of the NYSE provisions follows the Second Circuit's reading in *Fahnestock*. *Id. See supra* notes 85-96 and accompanying text.

138. *Id.* at 717-18.

139. *Id.* at 718.

140. *Id.*

141. *Id.* The U.S. Supreme Court's decision in *Moses H. Cone Memorial Hospital* was cited as authority for the federal policy favoring arbitration. *Id.* at 717.

142. *Id.* at 718

143. *Id.* The court observed that the FAA does not prefer any particular type of remedy. *Id.*

144. *Id.* The other circuit court decisions referred to are *Bonar* (11th Circuit), *Raytheon* (1st Circuit), *Cunard* (9th Circuit), and *Lee* (8th Circuit). *Id.*

145. *Id.*

146. *Id.*

to Illinois public policy.[147] The court found no such policy in Illinois that conflicts with the *Garrity* rule and actually found that Illinois disfavors arbitral awards of punitive damages.[148] Therefore, the court concluded that the parties' choice-of-law provision should be applied to preclude punitive damages because the parties did not specifically exclude the *Garrity* rule and the Agreement failed to explicitly grant the arbitrators power to make exemplary awards.[149]

V. COMMENT

The Court of Appeals for the Seventh Circuit faced a circuit split on the issue of arbitral awards of punitive damages. After considering the contrary views taken on the issue, the court decided to follow the line of cases limiting the availability of punitive damages. Judge Posner, writing for the Seventh Circuit in *Baravati v. Josephthal, Lyon & Ross, Inc.*,[150] summarized the difference between the instant case and contrary decisions as "simply a difference over the proper interpretation of the choice-of-law clause read in light of the parties' agreement to have their disputes arbitrated under rules that allow for the award of punitive damages."[151] Judge Posner aptly characterized the current dispute between the circuits through this concise assertion.

A. Interstate Commerce and Choice-of-law Provisions

Although the FAA is silent on the issue of punitive damages, it undoubtedly promotes settling disputes through the forum of arbitration.[152] There is also no doubt that the FAA applies to transactions involving interstate commerce.[153] Most securities agreements, like the one in the instant decision, involve interstate commerce and are generally governed by the FAA.[154] Once this is decided, the

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147. *Id.*

148. *Id.*

149. *Id.* at 717-19.

150. 28 F.3d 704 (7th Cir. 1994).

151. *Id.* at 709. Judge Posner completes his analysis by stating that other circuits believe that these provisions are best reconciled by confining the choice of law provisions to substantive matters, allowing the arbitrators free rein in procedural and remedial matters." *Id.*

152. Katsoris, *supra* note 2.

153. *Id. See also* Perry v. Thomas, 482 U.S. 483, 489 (1987) (holding that if an agreement to arbitrate evidences interstate commerce, the FAA requires parties to arbitrate dispute); *supra* notes 109-114 and accompanying text.

154. *Id.* 9 U.S.C. § 2 (1988). In Willis v. Shearson/Amer. Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983), the court noted that the "interstate character of the contract is evident [because] [t]his is a diversity action between a resident plaintiff and a foreign securities broker." *Id.* at 823. The court also found that "the Federal Arbitration Act applies to the arbitration provision . . . since that agreement is a written contract evidencing a transaction in interstate commerce." *Id.*

The court in Singer v. E.F. Hutton & Co., 699 F. Supp. 276 (S.D. Fla. 1988), found that "[t]he customer agreement . . . is 'a contract evidencing a transaction involving commerce,' therefore the Arbitration Act applies." *Id.* at 279. This finding led to the conclusion that "regardless of the

prevailing view is that a choice-of-law provision indicates only the substantive law to apply when determining whether the conduct involved warrants a punitive award and does not operate to restrict an arbitrator's authority to award punitive damages.[155] In the instant case, for example, New York substantive law would determine whether the defendant's conduct justifies an award of punitive damages. The more important determination, whether punitive damages are available, would be governed by federal law.[156]

The court, however, fails to address the interstate character of this case. Instead, it forgoes this analysis by concluding that the parties intended to settle their disputes subject to New York law and the *Garrity* rule.[157] By concluding that New York law is "the governing law of the agreement under all circumstances,"[158] the court also misinterprets the role of New York substantive law in this case. Although support can be found for the court's position, the predominant view concerning the availability of punitive damages directly contradicts this analysis.[159]

The court's reasoning follows closely the Second Circuit's treatment of the issue in *Fahnestock*. There, the court noted that absent a contrary agreement on the subject, state law would be preempted only if it actually conflicts with federal

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choice-of-law provision in the agreement (New York in this case), the court must be guided by federal law with respect to arbitral claims." *Id.* at 278. *See also Mendez*, 17 Cal. App. 4th at 1090, 21 Cal. Rptr. 2d at 830 ("[b]ecause the Case Account Agreement 'evidenced a transaction in interstate commerce,' the FAA applies."); *Raytheon*, 882 F.2d at 9 ("[s]ince the arbitration clause under consideration was part of a contract which affected interstate commerce, [respondent] is correct in its contention that the broad policies of the Federal Arbitration Act . . . govern our analysis."); *Bonar*, 835 F.2d at 1387 ("because the customer agreement evidenced a transaction in interstate commerce, it is governed by the Federal Arbitration Act.").

155. *Mendez*, 17 Cal. App. 4th at 1090, 21 Cal. Rptr. 2d at 830 ("[t]he choice-of-law provision [in the contract] merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants punitive damages; it does not deprive the arbitrators of their authority to award punitive damages."). Although the U.S. Supreme Court denied the petition for certiorari in *Mendez*, Justice O'Connor, with whom the Chief Justice joined, wrote a dissenting memorandum to the denial. *Mendez*, 114 S. Ct. at 2182. In her dissent, Justice O'Connor noted that the *Mendez* decision "is in accord with several federal decisions holding that the Arbitration Act preempts state law prohibitions on arbitral punitive damages awards." *Id.* She also stated that the *Mendez* decision "irreconcilably conflicts with [the instant case]." *Id.* at 2183.

See also Bonar, 835 F.2d at 1387 ("the choice-of-law provision does not deprive the arbitrators of their power to award punitive damages."); *Raytheon*, 882 F.2d at 11 n.5 ("the contract's choice-of-law provision does not require us to determine the punitive damages issue by looking to the law of the chosen forum"); *Willoughby*, 598 F. Supp. at 359 ("[a]lthough the parties to a contract can agree that a certain state's law will govern the resolution of issues submitted to arbitration, . . . federal law governs the categories of claims subject to arbitration.").

156. Katsoris, *supra* note 2.

157. *Mastrobuono*, 20 F.3d at 718. "Given our conclusion that the parties wished to arbitrate all of their disputes subject to *Garrity*, there is no need to consider whether the *Garrity* rule is preempted by the FAA or by the federal common law." *Id.*

158. *Id.*

159. *See generally supra* notes 70-79 and accompanying text.

substantive law.[160] In *Fahnestock* and the instant case, New York state law, the *Garrity* rule prohibiting arbitral awards of punitive damages, was applied because jurisdiction rested on diversity.[161] However, this position has been criticized by the Seventh Circuit as well as other courts.[162] Furthermore, there is authority which provides that parties wishing to arbitrate disputes rather than litigate them, should not have remedial powers restricted simply because the procedure they chose is not a traditional judicial forum.[163]

In *Baravati*, the court argued against the *Fahnestock* holding that "state common law of arbitration governs cases under the Federal Arbitration Act unless the parties have expressed their intentions not to be bound by it."[164] Judge Posner, writing for the court in *Baravati*, explained that such a rule would be "an implausible candidate for incorporation into the federal common law of arbitration" and concluded that "[s]tate common law hostile to arbitration is preempted by federal common law friendly to it."[165] The *Baravati* court also stated that the FAA applies to diversity cases affecting interstate commerce.[166] Since the instant case was based on diversity jurisdiction and affected interstate commerce, the FAA should have governed the Agreement. Once federal substantive law is invoked through the FAA, there is little doubt that arbitrators should be allowed to award punitive damages.[167]

B. Intent to Authorize Punitive Damages

After determining that the FAA does not apply, the instant case focuses on the intent of the parties to include punitive damages through incorporation of the

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160. *Fahnestock*, 935 F.2d at 518. The Second Circuit reiterated this analysis in its later *Barbier* decision. *Barbier*, 948 F.2d at 121.

161. *Mastrobuono*, 20 F.3d at 717; *Fahnestock*, 935 F.2d at 518.

162. *Baravati*, 28 F.3d at 711. The *Mendez* court criticized application of the *Garrity* rule on a different basis. The securities broker in that case admitted at trial and on appeal "that the sole reason for incorporating a New York law provision was to preclude punitive damage awards." *Mendez*, 17 Cal. App. 4th at 1904 n.9, 21 Cal. Rptr. 2d at 832. However, the broker "did not see fit to spell out that reason in plain language in the . . . Agreement, but instead, disguised it." *Id.*

163. *Raytheon*, 882 F.2d at 10. The court in *Raytheon* found it "sensible to interpret the 'all disputes' and 'any remedy or relief' phrases [contained in the agreement] to indicate, at a minimum, an intention to resolve through arbitration any dispute that would otherwise be settled in a court, and to allow the chosen dispute resolvers to award the same varieties and forms of damages or relief as a court would be empowered to award." *Id.*

164. *Id.* at 710. The court also stated that "[a]lthough *Fahnestock* is distinguishable from the present case, we will not be coy and attempt to conceal our disagreement with it." *Id.* at 710-11.

165. *Id.* at 711.

166. *Id.* at 707.

167. In *Singer*, the court found that "[i]f an issue is arbitrable under federal law, it remains so despite contrary state law." *Singer*, 699 F. Supp. at 276 ("Section 2 of the Arbitration Act evidences a desire to create a national policy favoring arbitration."). *See also Willis*, 569 F. Supp. at 824; Joseph P. Lakatos and Thomas G. Stenson, Note, *Punitive Damages Under the Federal Arbitration Act: Have Arbitrators Remedial Powers Been Circumscribed by State Law?*, 7 ST. JOHN'S J. LEGAL COMMENT 661 n.28 (1992).

NASD Code of Arbitration Procedures.[168] Under the Agreement, the Mastrobuonos could have chosen to arbitrate before either the NYSE or the NASD, both of which have been interpreted not to include punitive damages as within the scope of potential remedies.[169] However, the majority view takes a contrary position and would afford the language of those organizations a broader reading in light of their treatment of the issue.[170]

Although not specifically addressed within the rules of these organizations, both evince intent to allow arbitral awards of punitive damages.[171] The NASD Manual specifically addresses the issue of punitive damages and informs parties that arbitrators may consider punitive damages as a remedy.[172] The NYSE also demonstrates intent to include punitive damages as a possible remedy by providing a specific heading on the award form marked "punitive damages."[173] Courts taking the restrictive view of this language state that these organizations should have explicitly empowered arbitrators to award punitive damages if they intended to do so.[174] However, contrary authority holds that silence on the issue of punitive damages does not imply a lack of power to make such awards.[175]

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

169. *Id.* at 715. In *Jana*, the court determined that, although the NASD Manual specifically addresses the issue of punitive damages, only the Code was incorporated into the agreement. *Jana*, 835 F. Supp. at 412. In *Fahnestock*, the court determined that the NYSE Constitution and arbitration rules do not authorize arbitrators to award punitive damages because they fail to address the issue of remedies. *Fahnestock*, 935 F.2d at 519.

170. Three courts have found that an agreement contemplates punitive damages even though the NASD Code was incorporated into the agreement. In *Mendez*, the court determined that the NASD's failure to specifically address the issue of punitive damages did not expressly preclude arbitrators from awarding punitive damages. *Mendez*, 17 Cal. App. 4th at 1092, 21 Cal. Rptr. 2d at 831. Two different federal district courts within the Tenth Circuit also reached the same result. *Kelley*, 830 F. Supp. at 580 ("the incorporation of the NASD Code of Arbitration Rules provides the arbitration panel with the authority to award punitive damages"); *Pyle*, 758 F. Supp. at 640.

171. *See Mastrobuono*, 20 F.3d at 717; *Fahnestock*, 935 F.2d at 521 (Mahoney, J., dissenting).

172. *Mastrobuono*, 20 F.3d at 717; *see also Mendez*, 17 Cal. App. 4th 1083, 1092, 21 Cal. Rptr. 2d 826, 831.

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

174. *See supra* notes 84-96 and accompanying text.

175. The Securities Industry Conference on Arbitration (*see supra* note 45) does not specifically mention punitive damages, but contains the same language in it's Arbitrator's Manual as the NASD Manual. Katsoris, *supra* note 2. Katsoris finds more evidence of intent to include punitive damages as a possible remedy in the following language of the Conference's Code:

> Moreover, in order to prevent the insertion of restrictive clauses in customers' agreements, . . . the Code specifically prohibits conditions that 'limit or contradict the rules of the Securities Regulatory Organizations [the NASD is one of these], or limit the ability of a party to file any claim in arbitration or limit the ability of the arbitrators to make any award.' Although this prohibition does not specifically mention punitive damages, it clearly expresses a strong distaste for restrictions in customers' agreements which limit the claim or award rendered by the arbitrators. In this regard, choice-of-law provisions which . . . mandate the law to be applied in deciding the dispute, can be restrictive.

Id.

Chief among this authority, the Seventh Circuit in *Baravati* avers that "no negative inference can be drawn from the failure of the NASD's Code . . . to say anything about the scope of the arbitrators powers."[176] The instant case in fact draws a negative inference by finding that the language of the NASD Code does not authorize arbitrators to award punitive damages because it fails to specifically provide for such awards.[177] The norm, as stated by the *Baravati* court, is that "[s]ilence implies, given the tradition of allowing arbitrators flexible remedial discretion, *the absence of categorical limitations*."[178] Instead of viewing the NASD language as restricting the scope of available remedies in arbitration, the court could have taken a more expansive view, consistent with the interpretation given the AAA rules.[179] Liberal construction of the NASD Code language would further consistency among the circuits and provide predictability in accord with federal policy under the FAA.[180]

V. CONCLUSION

When a dispute arises between an investor and a broker, the chosen method to resolve the dispute should not involve a difference in the scope of possible remedies or the amount of potential relief.[181] The critical issue is that the investor should be able to rely on the same remedies, whether arbitration is chosen or traditional courtroom litigation.[182] In *Mastrobuono*, the court's restriction on the arbitrator's power to award punitive damages only furthers the conflict between the circuits. The result of this conflict is that "courts in different jurisdictions reach contrary results with respect to the availability of punitive damages in cases involving similarly situated parties and identical arbitration

176. *Baravati*, 28 F.3d at 710.

177. *Mastrobuono*, 20 F.3d at 717. The court stated that "[w]e do not think that [the] provision of the Manual authorizes an award of punitive damages in derogation of the governing law of the agreement." *Id.* The instant decision relied on Illinois policy disfavoring arbitral awards of punitive damages. *Id.* at 719. However, the *Baravati* court did not consider this an appropriate case to apply in the context of commercial arbitration. *Baravati*, 28 F.3d at 710. In addition, the *Baravati* court stated that "we do not think that a state policy based . . . on mistrust of arbitrators is a plausible candidate for incorporation into the federal common law of arbitration." *Id.*

178. *Id.* (emphasis added). Through this assertion, criticism of applying state policy hostile to arbitration and the criticism of the Second Circuit's treatment of punitive damages in *Fahnestock*, Judge Posner illustrates discontent with the instant decision.

179. Several courts have interpreted the language of the AAA to include punitive damages within the scope of remedies available in arbitration. *See supra* notes 100-104 and accompanying text.

In *Fahnestock*, the court distinguishes between the language of the NYSE and the AAA and implies that had the agreement incorporated the AAA rules, punitive damages may have been available. *Fahnestock*, 935 F.2d at 518-19.

180. In *Baravati*, the court noted that "[a]bout half of all registered broker-dealers belong to [the NASD]." *Baravati*, 28 F.3d at 708.

181. Katsoris, *supra* note 2.

182. *Id.*

agreements."[183] If the split in authority continues, a New York investor defrauded by a broker will not be entitled to the same relief as a California investor defrauded by the same broker.[184] Such a result is unsettling at best.[185]

ADDENDUM

The Supreme Court of the United States granted certiorari in *Mastrobuono* and an eight justice majority, headed by Justice Stevens, reversed the Seventh Circuit decision.[186] Justice Stevens, holding that the arbitral award of punitive damages should have been enforced, found punitive damages as an arbitrable issue under the terms of the parties' contract.[187] In addition, the Court found the Seventh Circuit's reading of the contract erroneous due to conflicting interpretations given the arbitration and choice-of-law provisions.[188] If punitive damages are determined to be within the contemplation of an arbitration agreement, the FAA guarantees enforcement of the agreement to arbitrate according to its terms, even if state law prevents arbitration of such claims.[189] Justice Thomas, the sole dissenter, rejected the majority's conflict between the arbitration and choice-of-law provisions and would have enforced the parties' contract according to New York law, which specifically prevents arbitrators from awarding punitive damages.[190]

Supreme Court precedent states that the FAA will enforce arbitration agreements, leaving for the majority the task of determining whether the parties included punitive damages as an arbitrable issue.[191] In making this determination, the Court focused on Paragraph 13, which contains the arbitration and choice-of-law provisions of the contract.[192] After examining each clause separately, the Court analyzed the meaning of the two provisions as a whole.[193] Beginning with the choice-of-law clause, the majority found this provision ambiguous regarding the exclusion of punitive damages for failure to specify whether New York substantive law or procedural law applies.[194] If both are applicable, New York's allocation of power between courts and arbitrators may prevent an arbitral award

183. J. Alexander Sec., Inc. v. Mendez, 114 S. Ct. 2182, 2183 (1993) (O'Connor, J., dissenting).
184. Katsoris, *supra* note 2.
185. *Id.*
186. Mastrobuono v. Shearson Lehman Hutton, Inc., 1995 WL 86555 (U.S. 1995).
187. *Id.* at *6.
188. *Id.*
189. *Id.* at *4.
190. *Id.* at *6, *9 (Thomas, J., dissenting).
191. *Id.* at *4. The cases relied upon by the Court are Allied-Bruce Terminix v. Dobson, 1995 WL 15045 (U.S. 1995); Perry v. Thomas, 482 U.S. 483 (1987); and Southland Corp. v. Keating, 465 U.S. 1 (1984).
192. *Mastrobuono*, 1995 WL 86555, at *4. *See supra* note 10 for a description of Paragraph 13.
193. *Id.*
194. *Id.*

of punitive damages under the facts of this case.[195] However, in adopting a restrictive reading of the choice-of-law clause as more appropriate, the Court held that only New York substantive law applies.[196] As to the arbitration provision, the Court found that the language of the NASD Code of Arbitration Procedures and Manual strongly suggests that punitive damages are available as a potential award.[197]

Finally, reading Paragraph 13 as a whole, the Court determined that the choice-of-law provision created ambiguity in the arbitration agreement which, in the alternative, would allow an award of punitive damages.[198] Keeping in mind that ambiguities regarding the scope of arbitration are to be resolved in favor of arbitration, the Court turned to principles of contract law to determine if the parties' agreed to arbitrate punitive damages.[199] First, the Court construed the contract against Shearson, as the drafter of an ambiguous contract.[200] Second, the interpretation offered by Shearson, that the choice-of-law and arbitration provisions contradict each other, violates the general contract law principle which requires interpreting a contract to afford consistency between its provisions.[201] In conclusion, the Court interpreted the choice-of-law provision to allow New York substantive law to apply, with the exception of "special" rules limiting the authority of arbitrators.[202] Furthermore, the arbitration provision governed the parties' rights regarding the scope of arbitral issues.[203] By this interpretation of Paragraph 13, the Court harmonized the two provisions to remove any potential intrusion imposed upon each other.[204]

For several reasons, Justice Thomas dissented with the majority and found that the FAA does not force arbitration on parties, rather it enforces an agreement to arbitrate in the manner provided by the parties.[205] Justice Thomas found the facts of this case indistinguishable from the facts of *Volt Information Sciences, Inc.*

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195. *Id.*

196. *Id.*

197. *Id.* at *5. Under the NASD Code of Arbitration Procedure § 41(e), arbitrators may award "damages and other relief." *Id.* *See also supra* note 134 and accompanying text. The Manual provided to NASD arbitrators specifically mentions punitive damages as a potential remedy: "The issue of punitive damages may arise with great frequency in arbitrations. Parties are informed that arbitrators can consider punitive damages as a remedy." *Id.*

198. *Id.*

199. *Id.* In *Moses H. Cone Memorial Hospital,* the Court stated that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability." *Mose H. Cone Mem. Hosp.,* 460 U.S. at 24-25.

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

201. *Id.* at *6.

202. *Id.* Under the *Garrity* rule, New York prevents arbitrators from awarding punitive damages. *See supra* note 59 and accompanying text.

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

204. *Id.*

205. *Id.* at *7 (Thomas, J., dissenting).

v. Leland Stanford Junior University,[206] wherein the Court enforced a choice-of-law provision, despite its "anti-arbitration" character.[207] Justice Thomas argues that the *Garrity* rule limiting arbitrators authority to award punitive damages is exactly the type of state law rule governing arbitration which *Volt* requires federal courts to enforce.[208] In addition, Justice Thomas found the majority's reading of the NASD Code and Manual unpersuasive.[209] The NASD Code fails to specifically address punitive damages and does not require that arbitrators be empowered to award punitive damages.[210] The Manual, although mentioning punitive damages, is not an official NASD document and should not be read to resolve the issue of punitive damages.[211] Under Justice Thomas's view, New York's express preclusion of punitive damages from arbitration as opposed to the silence of the NASD Code on the issue does not raise a conflict in which arbitration must ultimately prevail.[212] Justice Thomas concluded with a comment on the limited nature of the majority opinion.[213] By avoiding broad statements regarding preemption of state law by the FAA and deciding the case on general principles of contract law, the majority carved a narrow path with limited applicability.

Although the Mastrobuonos will receive their $ 400,000.00 punitive damages award, this decision can be regarded as a victory for Shearson because it does not limit their ability to draft future agreements excluding punitive damages as a potential remedy.[214] Shearson may avoid future punitive judgments by amending their arbitration provisions to expressly preclude punitive damages as an arbitrable issue. Investors, such as the Mastrobuonos, may lose all rights to receive punitive damages because the FAA requires enforcement of an agreement to arbitrate according to its terms.[215] The NASD has taken steps to avoid this result by enacting a rule which prohibits its members from drafting arbitration agreements limiting an arbitrator's ability to make any award.[216] However, this has no

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206. 489 U.S. 468 (1989).

207. *Mastrobuono*, 1995 WL 86555, at *7 (Thomas, J., dissenting). In *Volt*, the parties contract contained a choice-of-law clause and an arbitration agreement. *Id.*

208. *Id.*

209. *Id.* at *8.

210. *Id.*

211. *Id.* at *9.

212. *Id.*

213. *Id.* at *10.

214. In fact, the decision fails to mention whether securities brokers, in general, may draft contracts specifically excluding puntive damages. Joan Biskupic, *High Court Rules Against Brokerage; Justices Say Firms Can't Bar Punitive Damages in Arbitration Case*, WASH. POST, Mar. 7, 1995. However, Supreme Court precedent demonstrates a federal policy in favor of arbitration in general and will enforce an agreement to arbitrate as drafted by the parties. *Volt Info. Sciences*, 489 U.S. at 475.

215. *Mastrobuono*, 1995 WL 86555, at *4.

216. *Id.* at *5 n.6. Rule 21(f)(4) of the NASD Rules of Fair Practice states: "No agreement [between a member and a customer] shall include any condition which . . . limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." This Rule was inapplicable to the Mastrobuono's case because it was enacted in 1989 and the Mastrobuonos

effect on members of other associations and may not be enforceable in court. The Supreme Court did not improve investors' substantive right to recover punitive damages; it merely demonstrated how large brokers may avoid such penalties in the future.

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executed their agreement with Shearson in 1985. *Id.*