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AWARDING PUNITIVE DAMAGES IN SECURITIES INDUSTRY ARBITRATION: WORKING FOR A JUST RESULT

*Anthony Michael Sabino**

I. INTRODUCTION

It is often said that the business of America is business, and probably the best exemplifications of that old truism are the nation's stock exchanges. To be sure, not only stock, but bonds, options, commodities, futures, and a whole plethora of instruments are traded daily in exchanges large and small, in a seamless web straddling the country, if not the world.

When disputes over these transactions arise, as they must from time to time, it is now an accepted practice to submit such controversies to a panel of arbitrators for resolution. Arbitration is viewed as an expedient and less costly alternative to litigating in the federal or state courts; as such, it is an increasingly popular form of dispute resolution. While admittedly imperfect, arbitration generally works in that it resolves disputes with a lesser expenditure of time and resources. Thus, the parties may quickly return to the wilds of the trading floors and to the pursuit of profits.

Recently, a new issue has arisen regarding the scope of arbitrators' powers to award damages. Parties have challenged arbitrators' ability to award punitive damages¹ to a victorious party as part of an arbitral award. The legal question of whether arbitrators

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1. By definition, exemplary or punitive damages are awarded:

to punish the defendant for his evil behavior or to make an example of him, for which reason they are also called "punitive" or "punitory" damages or "vindictive" damages. Unlike compensatory or actual damages, punitive or exemplary damages are based upon an entirely different public policy consideration — that of punishing the defendant or of setting an example for similar wrongdoers, as above noted. In cases in which it is proved that a defendant has acted willfully, maliciously, or fraudulently, a plaintiff may be awarded exemplary damages in addition to compensatory or actual

can award punitive damages does not turn upon the pros and cons of arbitrators acting as policemen meting out punishment to wrongdoers. Rather, its determination requires resolution of the conflict between federal arbitration law and differing state law principles as to what damages in those forums arbitrators are permitted to award.

Not surprisingly, the answer to this question has significant financial repercussions for the securities industry, its customers, and for any other persons who submit to arbitration. This article first will explore the basic powers created by the Federal Arbitration Act ("FAA" or the "Act").² Next, it will examine two decisions of the United States Court of Appeals for the Second Circuit that have become lightning rods of controversy. In addition, this article will review the key precedents established in this area by the United States Supreme Court. Finally, possible methods for resolving this vitally important question will be suggested.

II. FEDERAL ARBITRATION — AN OVERVIEW

Before addressing the particular arbitration mechanism used in the securities industry, it is helpful to review the body of federal law that has established basic guidelines governing arbitration. Justice O'Connor drafted an eloquent introduction to this subject while writing for a majority of the U.S. Supreme Court in *Shearson/American Express, Inc. v. McMahon*:³

The Federal Arbitration Act, 9 U.S.C. §§ 1 [to 307], provides the starting point for answering the questions raised in this case. The Act was intended to "revers[e] centuries of judicial hostility to arbitration agreements," *Scherk v. Alberto-Culver Co., supra*, at 510, by "plac[ing] arbitration agreements 'upon the same footing as other contracts.'" 417 U.S., at 511, quoting H.R. Rep. No. 96, 68th Cong., 1st Sess., 1, 2 (1924). The Arbitration Act accomplishes this purpose by providing that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The Act also provides that a court must stay its proceedings if it is satisfied that an issue before it is arbitrable under the agreement, § 3; and it autho-

damages. Damages other than compensatory damages which may be awarded against [a] person to punish him for outrageous conduct.

BLACK'S LAW DICTIONARY 390 (6th ed. 1990).

2. 9 U.S.C. §§ 1-307 (1988 & Supp. II 1990).

3. 482 U.S. 220 (1987).

rizes a federal district court to issue an order compelling arbitration if there has been a "failure, neglect, or refusal" to comply with the arbitration agreement, § 4.⁴

The federal arbitration law was designed "to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate,"⁵ and, as Justice O'Connor noted, to place such agreements "'upon the same footing as other contracts.'"⁶ For these reasons, the U.S. Supreme Court has declared that it will "rigorously enforce agreements to arbitrate."⁷ Central to the statutory scheme of the FAA is section 2 thereof, which provides that "[a] written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."⁸

The provisions of the FAA pre-empt "arbitration agreements within the full reach of the Commerce Clause."⁹ As Justice Brennan resolutely pointed out in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,¹⁰ "Section 2 [of the FAA] is a congressional declaration of a liberal federal policy favoring arbitration agreements. . . . The effect of the section is to create a body

4. *Id.* at 225-26. *McMahon* clearly was the watershed in securities industry arbitrations, as it formally authorized arbitration of statutory anti-fraud claims made pursuant to the federal securities laws. *Id.* at 238.

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

6. *McMahon*, 482 U.S. at 225 (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-11 (1974)).

7. *Byrd*, 470 U.S. at 221.

8. 9 U.S.C. § 2. The full text of the statute reads as follows:

VALIDITY, IRREVOCABILITY, AND ENFORCEMENT OF AGREEMENTS TO ARBITRATE

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

Id.

9. *Perry v. Thomas*, 482 U.S. 483, 490 (1987). *But cf.* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 135-36 (1973) (holding that New York Stock Exchange rules militated against existence of a clear federal intent to require arbitration). *Ware's* relevancy now is questionable because of the considerable evolution of arbitration law since the case was decided.

10. 460 U.S. 1 (1983).

of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act."¹¹ The U.S. Court of Appeals for the Second Circuit later reaffirmed this analysis, stating that "Congress created national substantive law governing questions of the validity and the enforceability of arbitration agreements under its coverage."¹² Therefore, once a court, state or federal, determines that a dispute is covered by the FAA, federal substantive law, as set forth in the FAA and federal court decisions, will govern the scope and interpretation of the agreement.¹³

However, a curious duality exists in the FAA. In *Moses H. Cone Memorial Hospital*, Justice Brennan stated:

The Arbitration Act is something of an anomaly in the field of federal-court jurisdiction. It creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate, yet it does not create any independent federal-question jurisdiction under 28 U.S.C. § 1331 (1976 ed., Supp. V) or otherwise. Section 4 provides for an order compelling arbitration only when the federal district court would have jurisdiction over a suit on the underlying dispute; hence, there must be diversity of citizenship or some other independent basis for federal jurisdiction before the order can issue.¹⁴

As will be shown, this "anomaly" has played a role in the determination of whether arbitrators can award punitive damages and it continues to spark controversy.¹⁵

In the landmark case *Southland Corp. v. Keating*,¹⁶ the U.S. Supreme Court determined that California's highest state court had interpreted a state statute in direct conflict with the FAA. Therefore, the Supremacy Clause of the United States Constitution had been violated. Chief Justice Burger found that, in enacting the FAA, "Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the

11. *Id.* at 24.

12. *Genesco, Inc. v. T. Kakiuchi & Co.*, 815 F.2d 840, 845 (2d Cir. 1987).

13. *See, e.g., Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1211 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972) (holding all disputes covered by the Act, including "questions of interpretation, construction, validity, revocability and enforceability," will be governed by federal law).

14. *Moses H. Cone Memorial Hosp.*, 460 U.S. at 25 n.32.

15. *See infra* pp. 42-43 and notes 63-67.

16. 465 U.S. 1 (1984).

resolution of claims which the contracting parties agreed to resolve by arbitration."¹⁷

The majority opinion noted that the federal arbitration scheme rested "on the authority of Congress to enact *substantive* rules under the Commerce Clause."¹⁸ Continuing this constitutional analysis, Chief Justice Burger found earlier Court cases "implied that the substantive rules of the Act were to apply in state as well as federal courts."¹⁹ Logically, he continued, national lawmakers could address "a problem of large significance in the field of commerce" only by creating a pervasive scheme which included both federal and state courts.²⁰ Congress taking action pursuant to the Commerce Clause also supports the conclusion that the FAA was intended to apply to state courts.²¹ Finally, the legislative history of the FAA indicates that Congress contemplated this "broad reach."²²

It is apparent, therefore, that federal law controls the resolution of issues concerning an arbitration agreement's "interpretation, construction, validity, revocability, and enforceability."²³ If an issue is arbitrable under federal law, it remains so despite any contrary state law.²⁴ Some courts have found that federal law also governs the categories of claims subject to arbitration.²⁵

One could conclude that federal law has pre-empted any state involvement in this arena. However, this result is not clear cut, since the rationales relied upon by the U.S. Supreme Court have varied. On one hand, the justices have flatly stated that, in enacting the FAA, "Congress intended to foreclose state legislative at-

17. *Id.* at 10.

18. *Id.* at 11 (emphasis added); see also *id.* at 15 n.9 (noting "the [FAA] creates federal substantive law").

19. *Id.* at 12.

20. *Id.* at 13.

21. *Id.* at 14-15.

22. *Id.* at 13.

23. *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1211 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972).

24. See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 400 (1967). The U.S. Supreme Court concluded in *Prima Paint Corp.* that granting a stay in the face of contrary state law does not violate the *Erie* doctrine, since Congress, pursuant to the Commerce Clause, had authority to empower federal courts to grant stays when the conditions of sections 2 and 3 of the Act are met. *Id.* at 404-05.

25. *Supak & Sons Mfg. Co. v. Pervel Indus., Inc.*, 593 F.2d 135, 137 (4th Cir. 1979); *Becker Autoradio USA, Inc. v. Becker Autoradiowerk GmbH*, 585 F.2d 39, 43 (3d Cir. 1978).

tempts to undercut the enforceability of arbitration agreements."²⁶ But the Court has also determined that "[t]he FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."²⁷ Therefore, state law may be applied in arbitration matters, subject to pre-emption only "to the extent that it actually conflicts with federal law."²⁸

The impact of the conflicting U.S. Supreme Court precedents is exacerbated by the dissents in *Southland Corp.*,²⁹ especially the opinion written by Justice O'Connor and joined by Justice Rehnquist.³⁰ In her dissent, Justice O'Connor vigorously urged that the FAA's legislative history "establishes conclusively that the 1925 Congress viewed the FAA as a procedural statute," primarily because "Congress emphatically believed arbitration to be a matter of 'procedure.'"³¹ The dissent further contended that "[n]one of this Court's prior decisions has authoritatively construed the Act otherwise,"³² as both *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*³³ and *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*³⁴ involved federal court litigation, not state court proceedings. "The applicability of the FAA to state-court proceedings was simply not before the Court in either case."³⁵ Parenthetically, Justice O'Connor asserted that Congress never intended the FAA to create substantive rights,³⁶ nor to impose the full range of federal procedural requirements upon state tribunals.³⁷ The Justice explained that the FAA "should have no application whatsoever in state courts," and states should be given the opportunity to "fashion their own procedures" for arbitration.³⁸

26. *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984).

27. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477 (1989).

28. *Id.*; see also *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)(holding federal law pre-emption will apply where state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress").

29. 465 U.S. at 17.

30. *Id.* at 21 (O'Connor, J., dissenting).

31. *Id.* at 25.

32. *Id.* at 30.

33. 388 U.S. 395 (1967); see *supra* note 24.

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

35. *Southland Corp. v. Keating*, 465 U.S. 1, 30 (1984)(O'Connor, J., dissenting). Moreover, Justice O'Connor found that the Court's decision in *Prima Paint Corp.* omitted any suggestion that federal arbitration laws had to be applied by state courts. *Id.*

36. *Id.* at 30 n.19.

37. *Id.* at 31 n.20.

38. *Id.* at 31.

Also dissenting in part was Justice Stevens,³⁹ who found "it is by no means clear that Congress intended entirely to displace state authority in this field."⁴⁰ He opined:

The existence of a federal statute enunciating a substantive federal policy does not necessarily require the inexorable application of a uniform federal rule of decision notwithstanding the differing conditions which may exist in the several States and regardless of the decisions of the States to exert police powers as they deem best for the welfare of their citizens.⁴¹

In short, Justice Stevens believed differing state policies regarding what is arbitrable "can be recognized without impairing the basic purposes of the federal statute."⁴²

Notably, both Justice Stevens and Justice O'Connor reasserted their arguments three years later in *Perry v. Thomas*.⁴³ In *Perry*, Justice Stevens explained that in recent years, the U.S. Supreme Court had "effectively rewritten" the FAA "to give it a pre-emptive scope that Congress certainly did not intend."⁴⁴ Justice O'Connor commented in a similar vein, arguing that the FAA should not apply to state court proceedings.⁴⁵

From the foregoing discussion, the existence of a strong federal policy favoring arbitration is evident. While the FAA has created federal substantive law, its apparent supremacy and pre-emption of state law is not set in stone. However, in the end, Justice Brennan's determination that the FAA is binding in these disputes should be accorded substantial weight. As the Justice explained, "although enforcement of the Act is left in large part to the state courts, it nevertheless represents federal policy to be vindicated by the federal courts where otherwise appropriate."⁴⁶ Against this backdrop of somewhat conflicting principles, the scope of arbitrators' power to award punitive damages may be addressed.

39. *Id.* at 17 (Stevens, J., dissenting).

40. *Id.* at 18.

41. *Id.* at 19.

42. *Id.* at 21.

43. 482 U.S. 483, 493-95 (1987).

44. *Id.* at 493 (Stevens, J., dissenting).

45. *Id.* at 494 (O'Connor, J., dissenting).

46. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32 (1983).

III. THE SECOND CIRCUIT SPEAKS AGAINST PUNITIVE DAMAGES

As stated earlier, two decisions rendered by the U.S. Court of Appeals for the Second Circuit (the "Second Circuit") have become the focus of the controversy regarding the scope of arbitrators' powers. It is not surprising that this tribunal has taken the lead in addressing such matters, since the Second Circuit's jurisdiction includes the steel canyons of Wall Street, the ancestral home of the securities industry.

A. *Fahnestock & Co., Inc. v. Waltman*

The Second Circuit's first decision addressing the propriety of awarding punitive damages in securities industry arbitrations was *Fahnestock & Co., Inc. v. Waltman*.⁴⁷ In the process of closing down its retirement trust department, Fahnestock, a stock brokerage firm, dismissed Waltman. The discharge was not in dispute until Waltman refused to return certain insurance files Fahnestock claimed were its property.⁴⁸

The brokerage firm pressed for the return of the disputed files using New York Stock Exchange ("NYSE") arbitration procedures. Simultaneously, Fahnestock amended Waltman's Form U-5⁴⁹ and asserted that Waltman was the subject of an internal review due to suspected wrongdoing. Based upon the amended Form U-5, Waltman filed a counterclaim in the arbitration proceedings for defamation.⁵⁰

The arbitration panel decided in Waltman's favor and awarded damages against Fahnestock including \$100,000 in punitive damages. When the brokerage firm challenged the arbitrators' judgment in the United States District Court for the Southern District of New York, the court vacated the punitive damages portion of the award. In so doing, the court relied upon a state court decision

47. 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991), and *cert. denied*, 112 S. Ct. 1241 (1992).

48. 935 F.2d at 514.

49. Form U-5 is "a termination notice form that the National Association of Securities Dealers ("NASD") requires stock brokerage firms to file when they dismiss an employee."

Id.

50. *Id.*

prohibiting arbitrators from awarding punitive damages.⁵¹ The appeal to the Second Circuit followed.

Writing for the Second Circuit panel, Judge Miner first set out the basic premise that an arbitration award may be vacated where the arbitrators have exceeded their powers⁵² or where they have overtly disregarded the law.⁵³ The court then noted, “[w]e have consistently accorded the narrowest reading” to this statute.⁵⁴ Applying these standards, Judge Miner was not persuaded that the arbitrators had recklessly disregarded the law in awarding Waltman compensatory damages,⁵⁵ and the Second Circuit affirmed that part of the decision.⁵⁶

The question of the propriety of the arbitral award of punitive damages then was addressed. First, the tribunal found that the law of New York state prohibited the award of punitive damages by an arbitrator.⁵⁷ Nonetheless, Waltman argued that the FAA preempted state law; since the underlying agreement to arbitrate fell under the FAA and “include[d] no restriction on the award of punitive damages under the governing rules of the New York Stock Exchange, . . . there should be no bar to the award” of punitive damage to him.⁵⁸ The Second Circuit agreed with part of Waltman’s argument and stated that “there is precedent . . . that federal law and policy confers upon *FAA arbitrators* the right to award punitive damages even where, as is not the case here, the arbitration parties agree that New York law is to govern.”⁵⁹ Unfortunately for Waltman, the Second Circuit’s opinion rejected the remainder of the employee’s argument.⁶⁰

51. *Id.* at 514-15. The lower court relied upon *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976). *Garrity* had been subject to much criticism. See Thomas J. Stipanovich, *Punitive Damages in Arbitration*, *Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U.L. Rev. 953, 959 (1986) (calling *Garrity* “an anomaly, frustrating the goals of fairness and finality that are the essence of arbitration and undermining the valuable role that punitive damages play in deterring fraudulent or malicious conduct.”).

52. *Fahnestock*, 935 F.2d at 515 (citing 9 U.S.C. § 10(d) (1988)).

53. *Id.* (citing *Carte Blanche (Singapore) Pte., Ltd. v. Carte Blanche Int’l, Ltd.*, 888 F.2d 260, 265 (2d Cir. 1989)).

54. *Id.*

55. *Id.* at 516.

56. *Id.* at 517.

57. *Id.*

58. *Id.*

59. *Id.* (citing *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1386-88 (11th Cir. 1988); *Singer v. E.F. Hutton & Co.*, 69 F. Supp. 276, 278 (S.D. Fla 1988)) (emphasis added).

60. *Id.*

While acknowledging that the FAA's broad sweep pre-empts state laws that deter the enforcement of arbitration agreements, the appellate court found that the federal statutes do not completely pre-empt state law. Instead, the Second Circuit held that state law "may be applied in arbitration matters, subject to pre-emption only 'to the extent that it actually conflicts with federal law.'"⁶¹ Finding "no conflict between the provisions of the FAA" and the New York rule prohibiting the award of punitive damages in arbitrations, the Second Circuit determined that the arbitrators in this case were bound by the New York rule. For this reason, the arbitrators in this case were bound by the New York rule.⁶²

Judge Miner did note that the arbitration agreement was silent as to whether the arbitrators had the power to award punitive damages.⁶³ He explained that federal law might have permitted such an award "[i]f the parties had agreed" beforehand, because the "FAA provides for enforcement of the terms of such privately negotiated agreements."⁶⁴ The judge then queried if state law should be applied in situations "where the parties have not specified remedies and . . . the arbitrators therefore should be free to fashion appropriate relief."⁶⁵ He responded to his questions this way:

The answer lies in the jurisdictional basis of the action giving rise to this appeal. While 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. . . ." *Moses H. Cone*, 460 U.S. at 25 n. 32, 102 S. Ct. at 942 n.32. Some independent basis for federal jurisdiction must be established. The petition in the case at bar has invoked the diversity of citizenship of the parties as a means of acquiring subject matter jurisdiction. 28 U.S.C. § 1332. The award of the arbitrators was before the district court in this diversity case for review under state law. As previously noted, 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.⁶⁶

61. *Id.* (quoting *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 477 (1989)).

62. *Id.*

63. *Id.*

64. *Id.* at 518 (citing *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 478-79 (1989)).

65. *Id.*

66. *Id.*

In this fashion, the tribunal confronted the jurisdictional anomaly of the FAA, as pointed out earlier by Justice Brennan.⁶⁷

Because jurisdiction was predicated upon diversity of citizenship in this case, the Second Circuit relied upon the general rule that state law dictates the propriety of a punitive damages award in such disputes.⁶⁸ Finding the applicable New York prohibition to be substantive, the tribunal held it to be controlling in this controversy.⁶⁹

Notably, the Second Circuit panel left for another day what the result would be if the parties had specified in their arbitration agreement that punitive damages could be awarded. Judge Miner commented that the New York rule, "to the extent that it purports to prevent arbitrators from awarding punitive damages in the face of such an agreement, seems to invoke preemption concerns, since it runs afoul of the federal substantive law rules that sweep aside any state attempt to interfere with the agreement of the parties."⁷⁰ Here, however, there was no such private agreement, and the tribunal based its decision strictly upon the controlling NYSE arbitration rules which "are silent with regard to the power of arbitrators to award punitive damages."⁷¹ Consider this carefully drawn distinction:

As the district court observed, unlike the cases involving arbitration agreements incorporating the rules of the American Arbitration As-

67. See *supra* p. 36 and note 14.

68. *Id.* (citing *Browning-Ferris Indus. of Vermont, Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257, 278 (1989)). In fact, the U.S. Supreme Court "has never held, or even intimated," that an award of punitive damages implicates constitutional concerns. *Kelco Disposal, Inc.*, 492 U.S. at 259-60; see *Pacific Mut. Life Ins. Co. v. Haslip*, 111 S. Ct. 1032, 1044 (1991) (holding that a punitive damage award did not violate the Due Process Clause of the Fourteenth Amendment). *But cf. Kelco Disposal, Inc.*, 492 U.S. at 297-98 (O'Connor, J., dissenting) (finding the Excessive Fines Clause of the Eighth Amendment applies to punitive damages. This article does not enter the ongoing debate about the propriety, constitutional or otherwise, of awarding punitive damages. See *Haslip*, 111 S. Ct. at 1037-38.

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

70. *Id.*

71. *Id.* at 518-19. Interestingly, the scope of the arbitration guidelines of the major securities industry self-regulatory organizations ("SROs") is nearly all-encompassing regarding what disputes are arbitrable. See N.Y. STOCK EXCHANGE CONST., art. XI, § 1, reproduced at 2 N.Y.S.E. Guide [CCH] ¶ 1501, at 1075 (June, 1991) (holding "[a]ny controversy" is arbitrable); AMERICAN STOCK EXCHANGE CONST., art. VIII, § 1, reproduced at 2 Am. Stock Ex. Guide [CCH] ¶ 9062, at 2181 (October, 1989) ("all controversies"); NATIONAL ASSOCIATION OF SECURITIES DEALERS CODE OF ARBITRATION PROCEDURE § 1 pt. 1 & § 12 (a) pt. III, reproduced at NASD Sec. Dealers Manual ¶ 3701, at 3711, & ¶ 3712, at 3713 (April, 1992) (stating "[a]ny dispute, claim or controversy" is arbitrable).

sociation ("AAA"), which provide that arbitrators may award "any remedy or relief which [is] just and equitable and within the scope of the agreement," see *Bonar*, 835 F.2d at 1386 (upholding AAA award of punitive damages); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 9 (1st Cir. 1989) (same), the NYSE rules have no provisions relating to remedy or relief. Clearly, if the NYSE wanted to empower arbitrators to award punitive damages, it could have done so.⁷²

In a final attempt to recover punitive damages, Waltman claimed that the NYSE's arbitration award form contained a distinct heading "marked 'punitive damages.'"⁷³ The tribunal was not persuaded that the award form was part of the arbitration agreement and refused to allow the award of punitive damages on this basis. In a critical aside, the Second Circuit dryly added, "moreover, NYSE arbitrations occur throughout the nation, and our holding here does not mean that in those states in which arbitral punitive damages awards are permitted, arbitrators may not appropriately utilize the punitive damages section of the award form."⁷⁴ Also, in a parting note that may be of significance in the future, Judge Miner opined:

In a recent decision of this Court, the panel in dictum noted that "in an appropriate case, the arbitrators could enhance [an award] by punitive damages if prior misconduct established entitlement to such damages." *Kerr-McGee Refining Corp v. M/T Triumph*, 924 F.2d 467, 470 (2d Cir. 1991) (citing *Bonar*, 835 F.2d at 1387). In *Kerr-McGee*, the plaintiff was awarded treble damages under the Racketeer Influenced and Corrupt Organizations ("RICO") Act, 18 U.S.C. §§ 1961-1968, in an arbitration proceeding. 924 F.2d at 469-70. *Kerr-McGee*, however, was not a diversity case requiring a pre-emption analysis, since RICO there provided federal question jurisdiction under 28 U.S.C. § 1331.⁷⁵

One might speculate that the Second Circuit thereby created an escape hatch from *Fahnestock*.

For all of the reasons discussed above, the majority of the Second Circuit affirmed the vacatur of the punitive damages award,

72. *Fahnestock*, 935 F.2d at 519 (citation omitted).

73. *Id.*

74. *Id.*

75. *Id.*

leaving Waltman with only his compensatory recovery. However, the erudite dissent of Judge Mahoney is worth reviewing before concluding the analysis of *Fahnestock*.

Judge Mahoney argued that the panel's analysis "misreads the applicable law and creates an unnecessary conflict with two of our sister circuits."⁷⁶ Contending that the majority's reliance on a state law principle in an arbitration case was mistaken, the dissenting judge opined:

The majority's approach effectively disregards the existence of a "body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate," [*Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 N. 32 (1982)], and imposes the diversity regime of *Erie R.R. v. Tompkins*, 304 U.S. 64, 58 S. Ct. 817, 82 L.Ed. 1188 (1938). The *Erie* standard is intended, however, for "all matters except those in which some federal law is controlling." *Id.* at 72, 58 S. Ct. at 819. It therefore seems to me clearly inappropriate to apply *Erie*-generated rules to an area for which, the Supreme Court has instructed, federal law supplies the rule of decision. That, however, is precisely what the majority has done in this case.⁷⁷

In Judge Mahoney's view, the FAA requires federal district courts to direct that arbitration proceed in the matter previously agreed upon by the parties.⁷⁸ Therefore, "a state law which limits freedom of contract with respect to arbitration agreements covered by the FAA conflicts with the FAA and is preempted by it."⁷⁹

On that basis, the dissenting opinion concluded "the cases that have addressed the question whether punitive damages may be awarded in arbitration have looked to the agreement between the

76. *Id.* at 520 (Mahoney, J., dissenting).

77. *Id.*

78. *Id.*; see 9 U.S.C. § 4 (1988 & Supp. II 1990). In relevant part, the statute provides: A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28, in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . [T]he court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement.

9 U.S.C. § 4.

79. *Fahnestock*, 935 F.2d at 520 (Mahoney, J., dissenting); see *Saturn Distrib. Corp. v. Williams*, 905 F.2d 719, 722 (4th Cir.), cert. denied, 111 S. Ct. 516 (1990).

parties to resolve the issue” and have rejected efforts to preclude an arbitral award of punitive damages “even where the pertinent contract explicitly stated that it was to be governed by New York law.”⁸⁰ If such express contractual provisions to apply New York state laws were insufficient to enforce that forum’s punitive damages prohibition, certainly the “mere invocation of diversity jurisdiction” should not act as a bar in such cases.⁸¹

Furthermore, Judge Mahoney pointed out that the imposition of state rule of decision “without respect to (or any meaningful inquiry regarding) the contractual intention of the parties, directly contravenes the dominant purpose and policy of the FAA as repeatedly articulated by the Supreme Court.”⁸² Returning to the significance of the arbitration award form denoting a punitive damages category, Judge Mahoney found that “it is impossible on this record to reach any conclusion pro or con” as to the form’s legal effect.⁸³ For this reason, the dissent urged the panel to remand the case for reconsideration by the district court.⁸⁴

Critically, Judge Mahoney concluded that prior cases had not addressed whether the New York anti-punitive damages rule would preclude such awards in strictly FAA arbitrations. According to the dissenting judge, to give the rule such legal effect would be inconsistent with the Supreme Court’s “teaching that the FAA ‘creates a body of federal substantive law.’”⁸⁵ Judge Mahoney ended on this note:

Although our precedents are ambiguous, I conclude that governing Supreme Court doctrine, the vast weight of federal court authority on the issue, and basic principles of federal arbitration law counsel against the ruling of the majority in this case on the issue of punitive damages. I therefore respectfully dissent from that ruling.⁸⁶

80. *Fahnestock*, 935 F.2d at 521 (Mahoney, J., dissenting) (citations omitted).

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 522.

85. *Id.* (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n. 32 (1982)).

86. *Id.*

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

The Second Circuit reexamined this issue only a few months after handing down *Fahnestock*. In the case of *Barbier v. Shearson Lehman Hutton, Inc.*,⁸⁷ the result was the same; the court determined that punitive damages were an impermissible part of the arbitration award. Judge Miner again authored the opinion, this time for a different panel of the Second Circuit.

In this case, Bendelac, the plaintiffs' individual broker,⁸⁸ argued that the district court had incorrectly deferred to the provisions of the FAA rather than the New York rule prohibiting an arbitrator from awarding punitive damages. Recognizing that jurisdiction was predicated on diversity of citizenship, he further argued that the *Erie* doctrine demanded the forum's arbitration law be applied. The panel reached the result Bendelac desired, but for different reasons than those he articulated.⁸⁹

Looking at the facts, Judge Miner first quoted those relevant portions of the arbitration agreement that explicitly chose New York state law as controlling and gave the parties the option to arbitrate following either NYSE rules or National Association of Securities Dealers (NASD) regulations. The Barbiers had filed their claim to arbitrate with the NYSE. They were awarded judgment, including punitive damages.⁹⁰ As it had in *Fahnestock*, the Second Circuit confirmed the compensatory damages award. Interestingly, in its discussion, the court implied that the FAA is clearly superior to state law in such cases.⁹¹

Although Bendelac argued that the FAA was inapplicable, the tribunal found this "a strange contention because diversity jurisdiction serves as a basis for invoking the provisions of the FAA, not as a ground for invoking the application of a state arbitration statute."⁹² Rather, the court determined that the FAA does apply where there is federal subject matter jurisdiction, including jurisdiction by diversity, and where the agreement to arbitrate concerns

87. 948 F.2d 117 (2d Cir. 1991).

88. *Id.* at 120.

89. *Id.* at 118.

90. *Id.* at 119.

91. *See id.* at 120.

92. *Id.*; see *Smiga v. Dean Witter Reynolds, Inc.*, 766 F.2d 698, 703 (2d Cir. 1985), *cert. denied*, 475 U.S. 1067 (1986).

a transaction in interstate commerce.⁹³ The Second Circuit held that both requirements were undisputably met here.⁹⁴

On these grounds, the Second Circuit ruled that the Barbiers properly invoked the FAA to confirm the arbitral award, and added "[i]t is well-settled that judicial review of an arbitration award is narrowly limited."⁹⁵ Furthermore, the panel's decision rested in part upon the principle that courts generally do not look beyond the lump sum of an award to dissect the rationale of the arbitrators.⁹⁶

At this point it appeared that the *Barbier* panel had determined federal substantive law was controlling in many arbitration disputes. However, the tribunal refused to chart a course different from that followed in *Fahnestock*. Instead, the Second Circuit displayed a mild case of judicial schizophrenia: turning about one hundred and eighty degrees, the court rejected the punitive damages award.

The parties' arguments regarding the propriety of punitive damages awards were not surprising. Bendelac urged the court to apply New York's prohibition against awarding punitive damages because of requirements imposed by the *Erie* doctrine. In its amicus curiae brief, the Securities Industry Association took the same position, but based its view on the ground that the choice-of-law clause in the arbitration agreement directed that New York law be applied. The Barbiers, on the other hand, asserted that the FAA pre-empted the state rules of decision.⁹⁷

The Second Circuit held that *Fahnestock* foreclosed the plaintiffs' arguments.⁹⁸ Judge Miner found the relevant language of the arbitration agreement to be clear and convincing; New York law controlled. The judge explained, "[t]he FAA requires that private agreements to arbitrate be enforced in accordance with their

93. *Barbier*, 948 F.2d at 120.

94. *Id.*; see also *Willis v. Shearson/American Express, Inc.*, 569 F. Supp. 821, 823 (M.D. N.C. 1983). Notably, New York District Court Judge Ward held that the interstate commerce requirement was met because the transaction entailed "the purchase and sale of securities on a national exchange." *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151, 155 (S.D.N.Y. 1990), *aff'd in part, rev'd in part*, 948 F.2d 117 (2d Cir. 1991).

95. *Barbier*, 948 F.2d at 120-21.

96. *Id.* at 121 (quoting *Kurt Orban Co. v. Angeles Metal Sys.*, 573 F.2d 739, 740 (2d Cir. 1978)).

97. *Id.* at 121.

98. *Id.*

terms."⁹⁹ In this case, the parties' agreement to be bound by New York law terminated further options.¹⁰⁰

The Second Circuit panel relied in part upon language from the *Fahnestock* decision holding that the pre-emptive goal of the FAA was developed principally to expunge state laws hampering arbitration in derogation of freely negotiated agreements.¹⁰¹ Applying this rationale, the panel found that enforcing New York's prohibition against awarding punitive damages was fully consistent with federal arbitration law; as evinced by the inclusion of a choice-of-law provision,¹⁰² these parties "intended to be bound" by the New York rule. Interestingly, the court mentioned in passing that it would reach the same conclusion even if punitive damages would be permitted "in the absence of the choice-of-law provision."¹⁰³

Attempting to use the court's focus on the contract language to their advantage, the Barbiers classified the New York rule prohibiting arbitral awards of punitive damages as "arbitration law" and contended that the choice-of-law provision in the arbitration agreement "incorporates only state substantive law, and not state arbitration law."¹⁰⁴ Relying upon *Fahnestock*, the Second Circuit noted that the proper measure of damages in these cases is state substantive law, and the rule against punitive damages fits this definition.¹⁰⁵

In closing, the Second Circuit found the punitive damages award to the plaintiffs inappropriate primarily due to the choice-of-law provision in the parties' agreement. Since the FAA provides that an award may be vacated where the arbitrators exceed their powers,¹⁰⁶ that portion of the award was vacated.¹⁰⁷

99. *Id.* at 122 (quoting *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 478-79 (1989)).

100. *Id.*

101. *Id.* (citing *Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 380 (1991), and *cert. denied*, 112 S. Ct. 1241 (1992)).

102. *Id.*; see *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) (stating that "as with any other contract, the parties' intentions control").

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

104. *Id.*

105. *Id.*

106. See 9 U.S.C. § 10(a)(4) (Supp. II 1990). The full text of section 10(a) states:

(a) In any of the following cases, the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration —

(1) Where the award was procured by corruption, fraud, or undue means.

On these grounds, the Second Circuit held that arbitrators could not award punitive damages in securities industry arbitrations. However, these holdings are seriously out of step with the decisions of other federal tribunals and do not properly recognize the dominant role of the federal substantive law of arbitration. Indeed, neither *Fahnestock* nor *Barbier* sufficiently addresses the questions raised by Judge Mahoney's dissent in *Fahnestock*.

IV. FOR PUNITIVE DAMAGES — THE MAJORITY VIEW

Beyond cavil, the Second Circuit's recent holdings forbidding the award of punitive damages in arbitration proceedings are demonstrably at odds with the majority of federal court decisions permitting such awards. As will be shown below, the great weight of these decisions pre-empt restrictive state rules in favor of the clear supremacy of the FAA and its developing common law principles.

At the forefront of this body of precedent is a decision rendered several years prior to the eruption of the present controversy. In a prescient ruling, Chief Judge Hiram Ward of the Middle District of North Carolina held in *Willis v. Shearson/American Express, Inc.*¹⁰⁸ that:

Federal law, the Federal Arbitration Act, applies to the arbitration provision in the parties' account agreement since that agreement is a written contract evidencing a transaction in interstate commerce. Although the parties to a contract can agree that a certain state's law will govern the resolution of issues submitted to arbitration (*i.e.*, plaintiff's entitlement to punitive damages, assuming New York law applies), federal law governs the categories of claims subject to arbi-

(2) Where there was evident partiality or corruption in the arbitrators, or either of them.

(3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

(5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

9 U.S.C. § 10(a).

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

108. 569 F. Supp. 821 (M.D. N.C. 1983).

tration. . . . If an issue is arbitrable under federal law, it remains so despite contrary state law.

* * *

The Court perceives no public policy reason persuasive enough to justify prohibiting arbitrators from resolving issues of punitive damages submitted by the parties. Concluding that arbitrators may determine such issues comports with the principle that under the federal act "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. . . ." ¹⁰⁹

Notably, Chief Judge Ward's opinion in *Willis* was cited with approval by the other Judge Ward of New York in the original *Barbier* decision, since the arbitration provisions at issue were identical.¹¹⁰

Having established the foundation, it is necessary to examine the key decisions from the United States Courts of Appeals permitting arbitrators to award punitive damages.

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

At the vanguard of appellate cases permitting the award of punitive damages in arbitration proceedings is *Bonar v. Dean Witter Reynolds, Inc.*¹¹¹ In this case, the brokerage company had admitted liability on the compensatory damages claim,¹¹² leaving punitive damages as the "central factual issue for the arbitrators to decide."¹¹³ A panel of the Eleventh Circuit vacated the district court's approval of the punitive damages award, and remanded for a new hearing on that issue, but did so on the ground that the plaintiffs' "expert" witness had falsified his credentials and perjured himself on the stand.¹¹⁴

109. *Id.* at 823-24 (citations omitted); see also *Ehrich v. A.G. Edwards & Sons, Inc.*, 675 F. Supp. 559, 565 (D. S.D. 1987) (justifying award of compensatory damages, in part based on "strong federal policy in favor of upholding an arbitrator's ability to fashion appropriate remedies").

110. *Barbier*, 752 F. Supp. at 160. The consistency in the brokerage customer arbitration agreements can be accounted for by the fact that Shearson/AMEX in *Willis* was the predecessor to Shearson Lehman Hutton in *Barbier*.

111. 835 F.2d 1378 (11th Cir. 1988).

112. *Id.* at 1380 n.2.

113. *Id.* at 1380. In this case, the individual broker was found guilty of embezzlement and imprisoned. His name was Ed Leavenworth, an apropos surname, as the circumstances proved.

114. *Id.* at 1383-86.

The Eleventh Circuit's response to Dean Witter's arguments that the arbitrators lacked the authority to award punitive damages is noteworthy.¹¹⁵ Specifically, the brokerage firm claimed that the customer agreement between the parties did not contemplate an award of punitive damages in the arbitration proceedings. Alternatively, the defendant asserted that the plaintiffs had waived any right to punitive damages through the execution of the customer agreement.¹¹⁶ In fact, the arbitration agreement permitted hearings before the NYSE, the New York State Chamber of Commerce, or the American Arbitration Association ("AAA").¹¹⁷ The Bonars elected to proceed before the AAA.¹¹⁸

Judge Kravitch laid out the basic issue to be resolved. The AAA rules, incorporated by reference as a result of the parties' election to proceed before that body, authorized the arbitrators to award punitive damages. The rules broadly granted the arbitrators power to fashion any just remedy within the scope of the parties' agreement.¹¹⁹ However, the customer agreement had a choice-of-law provision favoring New York, *per force* triggering that state's rule prohibiting the award of punitive damages.¹²⁰ The panel had to determine if the choice-of-law provision excluded punitive damages from the scope of the parties' contract.¹²¹

The Eleventh Circuit found no such exclusion. Standing on its previous affirmance in *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*,¹²² the tribunal recalled that a nearly identical choice-of-law provision did not prevent an arbitrator from awarding punitive damages.¹²³ Significantly, in *Bonar*, the panel acknowledged that even the strong federal interest in promoting arbitration "would not override a clear provision in a contract prohibiting arbitrators from awarding punitive damages."¹²⁴ Judge Kravitch summarized the court's holding, stating:

115. *Id.* at 1386-87. The brokerage firm also claimed the punitive damages award "was so irrational as to be an abuse of the arbitrators' discretion." *Id.* at 1388. The court declined to consider that altogether because the issue of punitives had been remanded for a new hearing "where a new record would be developed." *Id.*

116. *Id.* at 1386.

117. *Id.*

118. *Id.* at 1380.

119. *Id.* at 1386.

120. *Id.* at 1386-87.

121. *Id.* at 1387.

122. 776 F.2d 269 (11th Cir. 1985), *aff'g* 598 F. Supp. 353 (N.D. Ala. 1984).

123. *Bonar*, 835 F.2d at 1387.

124. *Id.* at 1387 n.16 (citing *Willoughby Roofing & Supply Co.*, 598 F. Supp. at 364).

Without the choice of law provision, the appellees' customer agreement, like the contract in *Willoughby*, authorized the arbitrators to award punitive damages. Furthermore, because the customer agreement evidenced a transaction in interstate commerce, it is governed by the Federal Arbitration Act. *See* 9 U.S.C. § 2. Under the rule of construction announced in *Willoughby*, the addition of the choice of law provision does not deprive the arbitrators of their power to award punitive damages. Upon remand, the new panel of arbitrators is free to award punitive damages if it finds that the facts warrant such an award.¹²⁵

Finally, the appellate court rejected Dean Witter's waiver argument.¹²⁶ Chiding the agreement as "far from a model of clarity," the panel found the Bonars did not relinquish their right to punitive damages.¹²⁷ The issue of punitive damages was remanded for a new hearing.¹²⁸

The special concurrence of Judge Tjoflat in this case is noteworthy. While "agree[ing] that under circuit precedent the arbitrator in this case is not precluded from awarding punitive damages," the learned jurist struggled to understand "how punitive damages can ever be considered within the scope of the agreement of the parties' absent some express provision in the contract."¹²⁹ While explicitly stating he was not giving short shrift to federal policy aims here, Judge Tjoflat suggested that when parties contract to arbitrate, they are simply agreeing to resolve contractual issues in that mode.¹³⁰ He continued:

Whether [the scope of the agreement of the parties] can fairly be said to encompass the assessment of a penalty for willful or wanton misconduct, however, is extremely doubtful. Punitive damages are designed to serve the societal functions of punishment and deterrence; unlike contract remedies, they are not designed to vindicate the parties' contractual bargain. Consequently, absent an express provision in the contract, punitive damages should be considered as outside the scope of the parties' agreement and beyond the power of the arbitrator to award.¹³¹

125. *Id.* at 1387.

126. *Id.*

127. *Id.* at 1388.

128. *Id.*

129. *Id.* (Tjoflat, J., concurring).

130. *Id.*

131. *Id.* at 1389.

The concurring opinion asserted that the AAA rules recognized this principle by providing that arbitrators may award only those remedies within the scope of the parties' agreement. Other courts have applied this principle to support their decisions holding that arbitrators could not award punitive damages "absent an express provision in the contract."¹³² In unmasked criticism, Judge Tjoflat concluded, "I believe that our circuit's adherence to a different rule reflects a basic misunderstanding of the nature of punitive damages and the scope of arbitrators' remedial powers."¹³³

B. *Raytheon Co. v. Automated Business Systems, Inc.*

The U.S. Court of Appeals for the First Circuit also has addressed the instant controversy, but in a non-securities industry context, in the landmark case *Raytheon Co. v. Automated Business Systems, Inc.*¹³⁴ Interestingly, the opinion was rendered by Judge Reinhardt of the Ninth Circuit, sitting by designation.¹³⁵ As Judge Reinhardt wrote at the outset, "This case requires us to determine whether commercial arbitrators have the power and authority to award punitive damages pursuant to a general contractual arbitration clause which does not specifically provide for the award of such damages."¹³⁶

In *Raytheon*, the district court confirmed an arbitral award that included \$250,000 in punitive damages.¹³⁷ As in *Bonar*, the AAA rules of arbitration were applied.¹³⁸

Commencing its discussion of the case, the appellate court established that because the underlying transaction affected interstate commerce, "the broad policies of the [FAA] govern our analysis."¹³⁹ Alluding to the general comments made by the U.S. Supreme Court that any doubts concerning the scope of arbitration must be resolved in favor of arbitration, the First Circuit emphasized that "our conclusion that the arbitrators did not exceed their

132. *Id.* (citing *Howard P. Foley Co. v. IBEW, Local 639*, 789 F.2d 1421, 1424 (9th Cir. 1986); *International Ass'n of Heat & Frost Insulators & Asbestos Workers, Local 34 v. General Pipe Covering, Inc.*, 792 F.2d 96, 100 (8th Cir. 1986); *Baltimore Regional Joint Bd. v. Webster Clothes, Inc.*, 596 F.2d 95, 98 (4th Cir. 1979)).

133. *Id.*

134. 882 F.2d 6 (1st Cir. 1989).

135. *Id.* at 6.

136. *Id.*

137. *Id.*

138. *Id.* at 7.

139. *Id.* at 9 (citation omitted).

powers in awarding punitive damages in this case is predicated upon substantially more rigorous analysis.”¹⁴⁰

Turning to the text of the arbitration clause, the tribunal noted that: (a) the language unequivocally required all disputes to be settled by arbitration, and (b) the arbitration was to be held pursuant to AAA rules.¹⁴¹ As they had in *Bonar*, the AAA rules bestowed upon the arbitrators broad powers to fashion any remedy within the scope of the parties' agreement.¹⁴² The First Circuit panel combined these two observations to reformulate the issue as a determination of whether punitive damages were within the scope of the parties' agreement.¹⁴³

The court commented that, if it confined itself to the language of the arbitration clause, the text “was sufficiently broad to encompass the award of punitive damages,” especially since courts are to construe such agreements generously.¹⁴⁴ However, the tribunal went beyond the contractual language and examined the case law pertaining to this issue.¹⁴⁵

Raytheon argued that arbitrators must have explicit contractual authority to award punitive damages. However, the First Circuit disagreed, finding the cases that Raytheon cited in support of its position inapposite because they were labor arbitrations dominated by collective bargaining concerns that are “not present in a commercial arbitration context.”¹⁴⁶ Focusing on the commercial arbitration cases, therefore, the panel discussed the New York rule prohibiting punitive damage awards by arbitrators. Noting that the New York rule has been “sharply criticized,” this tribunal “de-

140. *Id.*

141. *Id.*

142. *Id.* at 9-10.

143. *Id.* at 10.

144. *Id.* (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985)).

145. *Id.*

146. *Id.* at 10-11; *cf.* *Miller Brewing Co. v. Brewery Workers Local Union No. 9*, 739 F.2d 1159 (7th Cir. 1984), *cert. denied*, 469 U.S. 1160 (1985) (award of punitive damages is beyond the scope of the collective bargaining agreement); *Bacardi Corp. v. Congreso de Uniones Industriales de Puerto Rico*, 692 F.2d 210 (1st Cir. 1982) (arbitrator awarding punitive damages exceeds his authority because such an award does not draw its essence from collective bargaining agreement). This point also undercuts Judge Tjoflat's special concurrence in *Bonar* where he cited labor arbitration cases in opposition to an arbitrator's power to award punitive damages in securities industry proceedings. *Bonar*, 835 F.2d at 1388. As the First Circuit correctly notes, the vastly different context of these two arbitration forums invalidates any significant correlation between them on this issue. *Raytheon*, 882 F.2d at 10-11.

cline[d] to adopt such a restrictive approach to arbitration here."¹⁴⁷

The First Circuit found *Bonar* to be the most prominent federal precedent on this issue,¹⁴⁸ and parenthetically adopted the view, held by a number of other courts, that choice-of-law provisions do not dictate the answer in the commercial arbitration setting; "[r]ather, we, like they, look to federal common law" to decide if punitive damages are appropriate.¹⁴⁹ The court stated that this conclusion was supported by the "parties' adoption of AAA rules . . . and the general canon that federal law governs the construction of arbitration agreements respecting interstate commerce."¹⁵⁰ The U.S. Supreme Court's decision in *Volt Information Sciences, Inc. v. Board of Trustees*¹⁵¹ did not change the First Circuit's conclusion, because in *Volt* the "scope of the arbitration agreement was not disputed."¹⁵² In *Raytheon*, on the other hand, the precise issue was one of scope: did the agreement encompass punitive damages?¹⁵³ Ultimately, *Raytheon* "conceded that federal law controlled."¹⁵⁴

For these reasons, Judge Reinhardt opined:

We . . . can see no reasoned justification for departing from the rule laid down by our colleagues in other parts of the nation. Like them, we agree that punitive damages can serve as an effective deterrent to malicious or fraudulent conduct. Where such conduct could give rise to punitive damages if proved to a court, there is no compelling reason to prohibit a party which proves the same conduct to a panel of arbitrators from recovering the same damages. Certainly, the fact that the parties agreed to resolve their dispute through an expedited and less formal procedure does not mean that they should be required to surrender a legitimate claim to damages. Parties that do wish arbitration provisions to exclude punitive damages claims are free to draft agreements that do so explicitly.¹⁵⁵

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

148. *Id.*

149. *Id.* at 11 n.5.

150. *Id.* at 11 (citations omitted).

151. 489 U.S. 468 (1989).

152. *Raytheon*, 882 F.2d at 11 n.5; see *infra* pp. 57-60.

153. *Id.*

154. *Id.* at 11.

155. *Id.* at 12.

Since no such exclusion existed in the instant agreement, the First Circuit upheld the award of punitive damages.¹⁵⁶

A substantial number of appellate court decisions stand counterpoised to the Second Circuit's holdings. The Eleventh and First Circuits have put forth the better argument, for their respective holdings correctly apply the dominant federal substantive law of arbitration which permits arbitrators to award punitive damages. *Bonar* is particularly telling, for it would authorize such awards in appropriate circumstances. At the same time, this decision recognizes that the parties' freedom to contract permits them to exclude punitive damages from any arbitral award.

V. *VOLT* — A KEY FOR THE CIRCUITS

Indispensable to this discussion are the U.S. Supreme Court's findings in *Volt Information Sciences, Inc. v. Board of Trustees*.¹⁵⁷ However, the mixed signals in Chief Justice Rehnquist's opinion make this holding a particularly difficult one to appraise. The basic question in *Volt* revolved around a California state law that allowed a court to stay arbitration proceedings pending the outcome of related litigation. The majority held that the application of California's statute was not pre-empted by the FAA where the parties had agreed that their arbitration would be governed by state law.¹⁵⁸

The agreement between the litigants in *Volt* had a choice-of-law clause selecting California law as the applicable law.¹⁵⁹ The parties also had contracted to abide by AAA rules.¹⁶⁰ The appellant argued that this did not *per force* mean California law controlled,¹⁶¹ and in any event, "questions of arbitrability . . . must be resolved with a healthy regard for the federal policy favoring arbitration."¹⁶²

Although conceding the broad policy goals of the FAA favor arbitration, the majority nevertheless held that the statutory body "does not confer a right to compel arbitration of any dispute at any time; it confers only the right to obtain an order directing that

156. *Id.*

157. 489 U.S. 468 (1989).

158. *Id.* at 470.

159. *Id.* at 474.

160. *Id.* at 470 n.1.

161. *Id.* at 474.

162. *Id.* at 475 (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 n.10 (1983)).

'arbitration proceed in the manner provided for in [the parties'] agreement.'"¹⁶³ While "due regard must be given to the federal policy favoring arbitration,"¹⁶⁴ it is not offensive under the FAA to apply state law in such disputes.

The context of this proceeding was vitally important; the case presented a question of proceeding "under a certain set of procedural rules . . . governing the conduct of arbitration — rules which are manifestly designed to encourage resort to the arbitral process."¹⁶⁵ Applying state law in this context simply did no violence to the federal policy favoring arbitration.¹⁶⁶

Therefore, the U.S. Supreme Court found nothing in the FAA to prevent the application of the California stay of arbitration statute. Chief Justice Rehnquist commented: "The FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."¹⁶⁷ Yet the Court hastened to add:

But even when Congress has not completely displaced state regulation in an area, state law may nonetheless be pre-empted to the extent that it actually conflicts with federal law — that is, to the extent that it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."¹⁶⁸

Returning to what the FAA does not do, the majority ruled it does not prevent parties "from excluding certain claims from the scope of their arbitration agreement. It simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms."¹⁶⁹

The Chief Justice acknowledged the cases in which the federal arbitration law was held to pre-empt state statutes.¹⁷⁰ Yet *Volt* was not such a case for these reasons:

163. *Id.* at 474-75 (quoting 9 U.S.C. § 4 (1988)) (emphasis in original).

164. *Id.* at 476.

165. *Id.*

166. *Id.* (citing *Bernhardt v. Polygraphic Co.*, 350 U.S. 198 (1956)).

167. *Id.* at 477.

168. *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)).

169. *Id.* at 478 (citations omitted); see also *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 n.12 (1967).

170. 489 U.S. at 478-79. Chief Justice Rehnquist stated:

[W]e have held that the FAA pre-empts state laws which "require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitra-

[I]t does not follow that the FAA prevents the enforcement of agreements to arbitrate under different rules than those set forth in the Act itself. Indeed, such a result would be quite inimical to the FAA's primary purpose of ensuring that private agreements to arbitrate are enforced according to their terms. Arbitration under the Act is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit.¹⁷¹

This, of course, includes the ability of the parties to "limit by contract the issues which they will arbitrate."¹⁷² By permitting enforcement of express terms even in derogation of the FAA, the Court claimed that it effectuated the contractual rights of the parties "without doing violence to the policies" of the FAA.¹⁷³

Justice Brennan, joined by Justice Marshall, dissented.¹⁷⁴ Justice Brennan agreed that the FAA does not pre-empt state arbitration rules, even for contracts involving interstate commerce, if the parties have agreed to abide by the state rules and exclude the federal law.¹⁷⁵ However, the dissent contended that the true issue was whether or not the parties had in fact contractually agreed to exclude the FAA, "[a]nd that question, we have made clear in the past, is a matter of federal law."¹⁷⁶ Justice Brennan asserted that the FAA established a body of federal substantive law.¹⁷⁷ In this context, the dissent took issue with the interpretation of the choice-of-law provision in the litigants' contract as an exclusionary clause. Justice Brennan proposed:

It seems to me beyond dispute that the normal purpose of such choice-of-law clauses is to determine that the law of one State rather than that of another State will be applicable; they simply do not

tion." *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984). *See, e.g., id.*, at 10-16 (finding pre-empted a state statute which rendered agreements to arbitrate certain franchise claims unenforceable); *Perry v. Thomas*, 482 U.S., [sic] at 490 (finding pre-empted a state statute which rendered unenforceable private agreements to arbitrate certain wage collection claims).

Id.

171. *Id.* at 479.

172. *Id.* (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985)).

173. *Id.*

174. *Id.* (Brennan, J., dissenting).

175. *Id.* at 481 n.4 (Brennan, J., dissenting); *see also id.* at 485 (citing *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582 (1960) ("[A] party cannot be required to submit to arbitration any dispute which he has not agreed so to submit.")).

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

177. *Id.* (Brennan, J., dissenting).

speak to any interaction between state and federal law. A cursory glance at standard conflicts texts confirms this observation: they contain no reference at all to the relation between federal and state law in their discussions of contractual choice-of-law clauses.¹⁷⁸

Furthermore, "settled principles of federal supremacy" dictate that the law of any chosen state includes federal law.¹⁷⁹ This is the only possible result, warned Justice Brennan, for

[w]ere every state court to construe such clauses as an expression of the parties' intent to exclude the application of federal law, as has the California Court of Appeal in this case, the result would be to render the Federal Arbitration Act a virtual nullity as to presently existing contracts.¹⁸⁰

Justice Brennan refused to believe that the parties here intended such a draconian outcome from a boilerplate choice-of-law clause.¹⁸¹

Volt plays a critical role in the resolution of the controversy over whether arbitrators should have the power to award punitive damages. While both the majority and the dissent express differences of opinion, there is ample legal reasoning in the decision that can be applied to sort out the competing interests within this controversy.

VI. ANALYSIS

We now come to the most difficult task — attempting to parse the foregoing case law into a cogent discussion for the purpose of resolving the instant controversy. Without doubt, this question of the power of arbitrators to award punitive damages in securities industry arbitrations is a very close one indeed.

178. *Id.* at 488 (Brennan, J., dissenting).

179. *Id.* at 490 (Brennan, J., dissenting); see *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 157 n.12 (1982); *Hauenstein v. Lynham*, 100 U.S. 483, 490 (1880); *Claffin v. Houseman*, 93 U.S. 130, 136 (1876).

180. 489 U.S. at 491 (Brennan, J., dissenting).

181. *Id.* at 491-92 (Brennan, J., dissenting).

A. *Federal Policy Favoring Arbitration*

As in any other legal analysis, it is important to consider the presumptions underlying the disputed question. Here, even a facial examination of the relevant dogma reveals a pervasive favoritism towards the federal law for regulating arbitration. The U.S. Supreme Court clearly has insisted that arbitration agreements be enforced according to their terms. Pursuant to both statute and common law, the decision to proceed to arbitration is a matter of contract, and not the whim of a judiciary sometimes jealously guarding its domain.

But the correct implementation of this federal policy is somewhat less clear. As demonstrated above, numerous statements by the Court have declared, in turn, that this national policy favoring arbitration (i) is rigorously enforceable by virtue of the Commerce Clause of the Federal Constitution; (ii) is an embodiment of federal substantive (and not procedural) law; and, (iii) by virtue of the Supremacy Clause, may on occasion pre-empt state law. These elements comprise a natural progression in law, each level gaining support and validity from its predecessor.

*Southland Corp. v. Keating*¹⁸² speaks particularly well to these points. Nevertheless, its dissenters made it plain that the Justices do not speak as one on the crucial points of federal supremacy and any concomitant pre-emption in this arena.¹⁸³ It is still true that the FAA lacks an express pre-emption provision, which has led the Supreme Court to hold that state law yet survives in some instances, overwhelmed by the federal law of arbitration only where the two bodies truly conflict. Notwithstanding the force of its Commerce Clause analysis in these matters, the Court still hesitates to find that Congress intended to occupy the entire field of arbitration. While proper respect and deference must still be given to the supremacy and pre-emption analyses already discussed, further guidance from the Court is necessary if we are to resolve the punitive damages issue.

182. 465 U.S. 1 (1984).

183. *Id.* at 21-36 (O'Connor, J., dissenting).

B. *The Role of Volt Information Sciences, Inc. v. Board of Trustees*

*Volt Information Sciences, Inc. v. Board of Trustees*¹⁸⁴ helps to provide this guidance. Clearly, the Court held that state law was not pre-empted in every eventuality by the FAA. However, it is noteworthy that the dispute in *Volt* had its locus in a procedural point, not an issue of substantive law. This major distinction could be dispositive in the instant controversy, for the prevailing view is that the awarding of punitive damages is a substantive legal issue. Therefore, the Supremacy and Commerce Clauses dictate that the issue of whether an arbitrator can award punitive damages ought to be determined by federal law.

Moreover, Chief Justice Rehnquist emphasized in *Volt* that the partial pre-emptive effect of the FAA mandated that arbitration be held in the manner that the parties agreed to by contract.¹⁸⁵ In so holding, the *Volt* majority opinion may, on one hand, de-emphasize the supremacy of the federal act, while simultaneously opening the portal to a possible avenue of resolution for the controversy. By acknowledging that, within the strictures of the FAA, parties retain power to dictate what issues they may or may not submit to arbitration, the *Volt* majority suggests that precedence must be given to the contractual analysis of what the parties have actually agreed to arbitrate, including any award of punitive damages. This would fulfill the Court's closing edict that the contract to arbitrate as made by the parties be honored and enforced according to its own terms, with due respect for the FAA and the strong federal policy favoring arbitration.¹⁸⁶

Cast in this light, Justice Brennan's dissent in *Volt* takes on increased importance. To be sure, Justice Brennan chose to reiterate the role of the FAA and its evolving case law as a substantive body. The supremacy of the federal jurisprudence thereby firmly established, it took just a short step for the dissent to criticize the excessive importance some courts attach to the choice-of-law clause found in typical arbitration agreements.

Being simultaneously true to both his view of the FAA as substantive law and the majority's will to enforce arbitration solely by

184. 489 U.S. 468 (1989).

185. *Id.* at 472.

186. *Id.* at 479.

the terms of the parties' contract, Justice Brennan implicitly combined the two views.¹⁸⁷ In so doing, he found that the federal law nevertheless prevailed, for choice-of-law clauses ordinarily resolve state-to-state conflicts, not state-to-federal law disputes, and, in any event, state law does *per force* include federal law, by virtue of the latter's preeminence.¹⁸⁸

This view recognizes the strong federal policy favoring arbitration by interpreting arbitration contracts in a way consistent both with the parties' wishes and the required supremacy of federal arbitration law. All of this is in accordance with Justice Brennan's essential holding in *Moses H. Cone* that the federal policy must be vindicated, notwithstanding the role that sometimes-conflicting state law may play.¹⁸⁹ On these grounds, it is clear that punitive damages awards in securities industry arbitrations are allowed under federal law in appropriate circumstances, and cannot be cancelled out where the federal substantive law and policy reign supreme.

C. Choice-of-Law — An Erroneous Selection

As we have seen, both *Fahnestock*¹⁹⁰ and *Barbier*¹⁹¹ devoted much discussion to and then relied upon the choice of law provision in the relevant arbitration contracts. It may be that this is exactly where the Second Circuit has been led down the wrong track in its analysis. By virtue of its two recent decisions, the Second Circuit is, among other things, according too much import to the choice-of-law provisions in the arbitration agreement when it finds that the selection of New York law mandates application of that state's anti-arbitral punitive damages rule.

A reading of *Volt* and the other relevant precedents of the U.S. Supreme Court, as previously suggested, dictates that the operative choice-of-law clauses do not exclude federal law. Rather, federal law is to be included. Because federal law embodies a strong policy favoring arbitration, the ability to arbitrate, including the awarding of punitive damages, should be enforced. To the extent that the state law conflicts with federal, it must be put aside.

187. *Id.* at 479-92 (Brennan, J., dissenting).

188. *Id.* at 489-91 (Brennan, J., dissenting).

189. *See supra* p. 39 and note 46.

190. *Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512 (2d Cir. 1991).

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

According the appropriate supremacy to federal arbitration law would also seem to solve the conundrum the Second Circuit created with respect to jurisdiction in *Barbier*.¹⁹² There, the panel found the FAA did apply in diversity cases where the transaction underlying the arbitration was one in interstate commerce.¹⁹³ While the court thus acknowledged the presence of federal subject matter jurisdiction, it nevertheless seemed to abandon that precept by citing the forum's prohibition against punitive damages as controlling.¹⁹⁴ This confusion must and can be resolved in the instant context, and correctly resolved in favor of the paramount role of the federal arbitration law.

Moreover, instead of avoiding the question by citing the fact that the parties' agreement in *Fahnestock* did not address the option of an award of punitive damages,¹⁹⁵ the Second Circuit should have interpreted that silence consonant with the federal law, and not the state prohibition against punitive damages awards. Even if federal pre-emption were not found, the parties' contractual choice of law could still accommodate federal law, which by its broad policy aims favors arbitration of all controversies, including punitive damages.

This bows to the *Volt* command that the contract to arbitrate be enforced by its own terms. Indeed, Judge Miner's positing of the unanswered question of what the result would be if the parties had agreed to permit punitive damages awards, in light of New York's rule against such awards,¹⁹⁶ speaks mightily towards the *Fahnestock* court's internal reservations, and denotes a possible future acceptance of the course charted above.

It is well accepted that the federal policy mandates 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."¹⁹⁷ Why then does the Second Circuit resist the application of the FAA and then defer to a state rule where, as is clear in *Barbier*, the language of the arbitration agreement explicitly insists that *any* controversy must be sub-

192. *Id.*

193. *Id.* at 120.

194. *Id.* at 121-22.

195. 935 F.2d at 517.

196. *Id.* at 518.

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

mitted to arbitration?¹⁹⁸ To be sure, it has been recognized elsewhere that parties may contractually authorize their arbitrators to award punitive damages.¹⁹⁹ This is certainly consistent with the *Volt* edict on enforcing an arbitration contract according to its own terms.

Furthermore, in past Second Circuit decisions it appeared well-settled that federal arbitration law applied to contracts embraced by the FAA, even where a New York choice-of-law provision was within the agreement at issue.²⁰⁰ Those earlier rulings placed the tribunal in the mainstream, for other courts have held likewise.²⁰¹

D. *Staying the Narrow Road for Reversal*

Among other things, the Second Circuit failed to reconcile its usurpation of the arbitrators' awards in both *Fahnestock*²⁰² and *Barbier*²⁰³ with its own relevant precedents. For instance, the Second Circuit has consistently accorded the narrowest of readings to the FAA's authorization to vacate awards based upon section 10 of that statutory scheme.²⁰⁴ Indeed, even Judge Miner in *Fahnestock* acknowledged the tribunal's distaste for anything but a narrow reading of the vacatur provision.²⁰⁵ Although professing not to violate that principle in its recent holdings, the reality is glaringly to the contrary — the circuit bench is all too willing to intercede and circumvent the arbitrators' judgment.

198. See *Barbier v. Shearson Lehman Hutton, Inc.*, 752 F. Supp. 151, 159-60 (S.D.N.Y. 1990).

199. See *Totem Marine Tug & Barge, Inc. v. North Am. Towing, Inc.*, 607 F.2d 649, 651 (5th Cir. 1979) (arbitrators derive their authority from the scope of the contractual agreement); *Lundgren v. Freeman*, 307 F.2d 104, 109-110 (9th Cir. 1962) (scope of arbitrator's authority rests on the parties' agreement).

200. See, e.g., *I/S Stavborg v. National Metal Converters, Inc.*, 500 F.2d 424 (2d Cir. 1974) ("New York courts, in dealing with arbitration disputes where the contract involves interstate commerce, apply federal, and not state, arbitration law" notwithstanding a provision in the parties' agreement that it be governed by New York law); *Masthead Mac Drilling Corp. v. Fleck*, 549 F. Supp. 854, 856 (S.D.N.Y. 1982) (quoting *Rothberg v. Loeb, Rhoades, & Co.*, 445 F. Supp. 1336 (S.D.N.Y. 1978)).

201. See, e.g., *New England Energy, Inc. v. Keystone Shipping Co.*, 855 F.2d 1, 4 n.2 (1st Cir. 1988), cert. denied, 489 U.S. 1077 (1989); *Apex Fountain Sales, Inc. v. Kleinfeld*, 818 F.2d 1089, 1094 n.4 (3rd Cir. 1987); *Mesa Operating Ltd. Partnership v. Louisiana Intrastate Gas Corp.*, 797 F.2d 238, 243-44 (5th Cir. 1986).

202. *Fahnestock & Co., Inc. v. Waltman*, 935 F.2d 512 (2d Cir. 1991).

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

204. See, e.g., *Andros Compania Maritima, S.A. v. Marc Rich & Co., A.G.*, 579 F.2d 691, 703 (2d Cir. 1978).

205. See *Fahnestock*, 935 F.2d at 515.

Indeed, why should an award of punitive damages be beyond the power of an arbitrator? Any distinction is purely contrived, for arbitrators may decide matters of treble damages under both civil RICO²⁰⁶ and the antitrust laws.²⁰⁷ Once again, even in *Fahnestock* the Second Circuit noted that it had previously allowed a RICO treble damage award to proceed in an arbitration.²⁰⁸ Given that tribunal's acknowledgement of such outcomes in its own jurisdiction, why not permit punitive damage awards in securities industry arbitrations as well? No rational reason exists for a contrary rule.

E. *A Much Needed Reconciliation*

It is also vitally important to reconcile the recent decisions of the Second Circuit against awarding punitive damages in securities industry arbitrations with the majority view of other federal courts on the controversy, lest this inter-circuit dichotomy escalate. The other tribunals appear to have the better of the argument, being guided primarily by a broad application of federal policy favoring arbitration, including the award of punitive damages.²⁰⁹ These courts have rightly found that the federal mandate to allow arbitration to proceed unencumbered necessarily allows the arbitrator to fashion appropriate remedies for the fair and equitable resolution of the parties' dispute. If such a cure includes punitive damages, so be it. A bright-line distinction between compensatory and punitive damages is not called for, does not serve the interests of justice, and fails to serve the federal policy of fostering level forums for arbitration across the nation.

In *Bonar*, the Eleventh Circuit recognized these elements when it found that the parties' choice-of-law clause did not preclude an award of punitive damages.²¹⁰ That tribunal accorded the proper respect to the federal mandate by not excluding a punitive damages award on the basis of a contrary state law. Moreover, the panel implied that had the parties specifically contracted to exclude punitive damages, their wishes would have to be respected.²¹¹

206. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 238 (1987).

207. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 635 (1985).

208. *Fahnestock*, 935 F.2d at 519 (citing *Kerr-McGee Ref. Corp. v. M/T Triumph*, 924 F.2d 467 (2d Cir. 1991)).

209. *See, e.g., Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988).

210. *Bonar v. Dean Whitter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988).

211. *Id.* at 1387-88.

Bonar thereby satisfied the primary concerns raised by the U.S. Supreme Court in the *Volt*²¹² decision, by enforcing federal arbitration law to its full extent without encroaching on private contract interests.²¹³

*Raytheon Co. v. Automated Business Systems, Inc.*²¹⁴ proceeds in company with *Bonar*, as it too garners authority for federal supremacy from the Commerce Clause analysis often relied upon by the High Court.²¹⁵ The First Circuit provides some notable input about the arguments typically made regarding whether the scope of the parties' agreement to arbitrate necessarily contemplates an award of punitive damages.²¹⁶ Interpreting the sweeping language of the arbitration clause that all disputes must be arbitrated and the similarly broad coverage of the applicable AAA rules,²¹⁷ this tribunal easily found that an award of punitive damages was within the parties' agreement to arbitrate.²¹⁸

Certainly, the First Circuit did not torture the meaning of either the contract or the AAA rules to reach this result. Rather, its reading of the text was straightforward, setting an example to be followed elsewhere. Critically, the tribunal also made its holding with a full awareness of *Volt* and all its conflicting nuances.²¹⁹ Indeed, one could venture that *Raytheon* is a natural and welcome outcome of the principles espoused by Chief Justice Rehnquist in that High Court landmark.

In sum, the foregoing analysis clearly points to the same result — punitive damages may be awarded in securities industry arbitrations. The overriding federal law and policy mandates, the better and majority view of the circuits, and all of the other points analyzed above, lead away from the Second Circuit's recent decisions espousing contrary results. Having determined that, however, what will be its impact on the securities industry?

212. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468 (1989).

213. *See supra* p. 62 and notes 185-86.

214. 882 F.2d 6 (1st Cir. 1989).

215. *Id.* at 10-11.

216. *Id.* at 9.

217. *Id.* at 9-12.

218. *Id.* at 11-12 n.5.

219. *Id.*

VII. PUNITIVE DAMAGES — A CLEAR AND PRESENT DANGER TO THE SECURITIES INDUSTRY

This writing espouses the position that, in the proper circumstances, punitive damages may be awarded by arbitrators in securities industry disputes. However, one crucial point that this article does not intend to minimize is the danger this line of legal reasoning presents to the securities industry.

Still shaking off the effects of the 1987 "Black Monday" stock market crash and the lingering doldrums of the recession, the industry does not need the incredible potential for harm that awards of punitive damages engender. Having hailed arbitration as an enormous savings of time and resources that would otherwise be diverted into unprofitable litigation, and only recently having won a hard-fought victory to compel arbitration of all customer claims in *Shearson/American Express, Inc. v. McMahon*,²²⁰ the securities industry may suffer a tremendous setback if arbitrators are given the power to award punitive damages.

While finding that the weight of authority clearly bestows the power to award punitive damages upon the arbitrators in most cases, this writer is by no means insensitive to the crushing burden this conclusion may entail. Consider the unique status accorded punitives damages by Justice O'Connor:

[P]unitive damages are quasi-criminal punishment. Unlike compensatory damages, which serve to allocate an existing loss between two parties, punitive damages are specifically designed to exact punishment in excess of actual harm to make clear the defendant's misconduct was especially reprehensible. Hence, there is a stigma attached to an award of punitive damages that does not accompany a purely compensatory award. The punitive character of punitive damages means that there is more than just money at stake.²²¹

How should the industry protect itself from possible debilitating results? Clearly, the answer does not lie in hiding behind state law prohibitions against arbitrators awarding punitive damages. Such defenses are mere Maginot Lines, easily outflanked by the overpowering forces of federal supremacy and the other rationales out-

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

221. *Pacific Mut. Life Ins. Co. v. Haslip*, 111 S. Ct. 1032, 1062 (1991) (O'Connor, J., dissenting).

lined above. Moreover, such restrictions are not uniform among the fifty states, and, as New York has demonstrated, are often subject to criticism within their own forums. Indeed, such criticism may foster a change that destroys the last rampart of protection for the industry. Thus, the now discredited choice of law proposition affords no comfort in light of today's developments in the law.

But what does remain a formidable bulwark against punitive damage awards in securities industry arbitrations is the arbitration contract itself. As alluded to in *Volt*, and adhered to by courts awarding punitive damages, the parties' freedom to agree as they see fit allows them to contractually exclude any award of punitive damages from a subsequent arbitration of their disputes.²²² This proposition stands unchallenged; obviously so, because it goes to the very heart of the contractual freedom to fashion arbitration agreements in any manner the parties choose. Once structured, it is this individualized format that the federal courts must rigorously enforce, even if punitive damage awards are thereby excluded.

Thus, the path to be taken is clearly marked. The securities industry needs to clearly define its arbitration contracts as precluding any arbitrators' award of punitive damages. This may be easier said than done, for bodies such as the AAA do not include such a prohibition in their own rules of arbitration. Yet, the explicit agreement of the parties regarding the scope of the contract to arbitrate should overcome any contrary rules of the arbitration organization.

The viability of such contractual exclusions of punitive damages from industry arbitration agreements is uncertain. Customers may simply refuse to agree to such clauses or subsequently challenge them later as contracts of adhesion. Another possibility is that the public, in the official form of Congress or the Securities and Exchange Commission, may enter the fray and promulgate statutes or regulations to outlaw or restrict such a preclusion.

Given the danger punitive damage awards present to the securities industry, and the potential for intervention by the federal government, the stock brokerages are advised to proceed cautiously. Among other things, it is suggested here that the securities industry mobilize its forces not just to protect its interests by trying to

222. See, e.g., *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 478-79 (1989).

contractually preclude arbitral awards of punitive damages, but also to seek the creation of new parameters which would at least ensure that the awarding of punitive damages, if allowed, is done in a responsible way. Since it is quite conceivable that punitive damages are now a fixed part of the arbitration landscape, the securities industry can rightly take appropriate countermeasures to make sure their draconian effect does not go unchecked.

VIII. CONCLUSION

The awarding of punitive damages in securities industry arbitrations is a sensitive and controversial issue. On one hand, wronged plaintiffs crave retribution from the malefactor and society seeks to deter future misconduct by meting out punishment. On the other hand, the securities industry, having recently emerged victorious in its struggle to compel arbitration in these disputes, now faces the potential for devastating harm if punitive damage awards become the rule of the day. How are these competing interests to be reconciled?

In deliberating upon this question, the one constant that must be remembered is that the federal arbitration law evinces a congressionally mandated policy of favoring the enforcement of the parties' agreement to arbitrate. Founded upon the Commerce Clause of the U.S. Constitution, the federal law must reign supreme. To be sure, explicit federal pre-emption is lacking, thus leaving any surviving state law to play a part in such proceedings. Nevertheless, the bias towards the strong federal policy to favor arbitration must be accorded a "healthy respect."

The controversy has now reached groundswell proportions, as the Second Circuit has declared that punitives cannot be awarded by arbitrators. By relying upon the forum state's prohibition against such outcomes in arbitration, this tribunal has taken a diametrically opposite view from its brethren on this subject. It is respectfully suggested here that the appellate court's rationale is flawed, and the majority and better view allowing arbitrators to award punitive damages in appropriate circumstances should prevail for securities industry arbitrations.

The teachings of the U.S. Supreme Court, while confusing at some junctures, still clearly accommodate the awarding of punitive damages in arbitration. Among other decisions, *Volt Information*

*Sciences, Inc. v. Board of Trustees*²²³ tacitly endorses such latitude, as long as the arbitration contract is enforced according to its own terms. Certainly, the great weight of guidance from the High Court, and the implementation thereof by numerous lower tribunals, proves there is no reason to simply exclude punitive damage awards from arbitration. Even the Second Circuit acknowledges this, as a matter of federal law.

It seems that the sticking point is forum state rules which ban the giving of punitive awards by arbitrators. Yet, it is contended here, such edicts must fail because of the supremacy of the federal law of arbitration, which contains no such prohibition. Any other result simply elevates state law over federal, on what is unquestionably an issue of federal substantive law. Such a result is not proper.

What the U.S. Supreme Court decisions and their progeny do tell us is that the agreement to arbitrate must be enforced by the terms contracted to by the parties. Certainly, if the parties agreed to exclude an award of punitive damages from the arbitrators' powers, so be it: contractual freedom among private parties demands that their wishes regarding how to structure their own arbitration must be honored, including any prohibition against the awarding of certain categories of damages. But if the agreement is silent, the supreme power of the federal law must control, and that jurisprudence permits punitive damage awards by arbitrators.

This being the case, it is now up to the securities industry to meet the challenge thus offered. If punitive damages are authorized by law, the stock brokerages must exercise their inherent freedom of contract to specifically agree beforehand that such awards are excluded from future arbitrations. Because those efforts may meet with public or regulatory opposition, the securities industry should immediately start to take a proactive role in promulgating appropriate rules for industry arbitrations.

While any new rules need not necessarily prohibit an award of punitive damages, such new regulations should operate to confine their use to rightful and appropriate circumstances. As Justice O'Connor recently noted:

Punitive damages are a powerful weapon. Imposed wisely and with restraint, they have the potential to advance legitimate state inter-

223. 489 U.S. 468 (1989).

ests. Imposed indiscriminately, however, they have a devastating potential for harm.²²⁴

The securities industry must take up the gauntlet in its chosen forum of arbitration, and assure that if punitive damages are to be awarded, they serve society's interest in doing justice on the whole, without harming our vital financial services industry.

224. *Pacific Mut. Life Ins. Co. v. Haslip*, 111 S. Ct. 1032, 1056 (O'Connor, J., dissenting).