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# Mastrobuono v. Shearson Lehman Hutton, Inc.

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## *Mastrobuono v. Shearson Lehman Hutton, Inc.*

### I. *MASTROBUONO V. SHEARSON LEHMAN HUTTON, INC.*—THE FACTS

On March 6, 1995, in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,<sup>1</sup> the United States Supreme Court resolved a conflict among federal circuit courts by upholding an arbitrator's power to award punitive damages when a brokerage agreement contains a New York choice-of-law clause. A New York choice-of-law clause is important because New York law allows only courts, not arbitrators, to award punitive damages. This restriction on an arbitrator's power to award punitive damages is known as the Garrity Rule.<sup>2</sup> Many brokerage firms, including Shearson Lehman, are based in New York and have New York choice-of-law clauses in their brokerage agreements.

Antonio and Diana Mastrobuono opened a securities trading account with Shearson Lehman Hutton, Inc. by executing Shearson's standard-form Client's Agreement. The Mastrobuonos closed the account after two years and filed suit, claiming Shearson had mishandled their account. Damages were claimed under various state and federal law theories. The claim specifically alleged "churning," a claim which rests on the theory that the broker caused securities in the client's account to be traded with a frequency or amount too great in light of the client's needs and the nature and size of the client's account. Churning would have resulted in higher commissions to Shearson.<sup>3</sup> The client agreement contained an arbitration provision and a New York choice-of-law provision.<sup>4</sup> After suit was filed in federal district court, Shearson filed a motion to stay the court

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1. 115 S. Ct. 1212 (1995).

2. *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 796 (1976). The *Garrity* court held that arbitrators have no power to award punitive damages even if the arbitration agreement specifically provides for such a remedy. The court reasoned that allowing an arbitrator to award punitive damages would encroach upon the functions of the court and jury and displace the State as the "engine for imposing a social sanction."

3. Michael S. Wilson, *Punitive Damages in the Arbitration of Securities Churning Cases*, 11 Rev. Litig. 137, 139 (1991).

4. *Id.* at 1216. Paragraph 13 of the Client's Agreement provided:

This agreement shall inure to the benefit of your [Shearson's] successors and assigns[,] shall be binding on the undersigned, my [petitioners'] heirs, executors, administrators and assigns, and shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [my] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange Inc. as I may elect.

*Id.* at 1216-17 n.2.

proceedings and to compel arbitration under 9 U.S.C. §§ 3<sup>5</sup> and 4.<sup>6</sup> The court granted the motion, and the Mastrobuonos brought their claims before the National Association of Security Dealers (NASD). The arbitration panel awarded punitive damages in the amount of \$400,000 and compensatory damages in the amount of \$159,327.<sup>7</sup> The district court vacated the award because the contract contained a New York choice-of-law provision, and thus, the contract was governed by the Garrity Rule.<sup>8</sup> The district court relied on *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*<sup>9</sup> and held that the "liberal policy favoring arbitration did not provide any basis for ignoring choice-of-law provisions in arbitration agreements."<sup>10</sup> The district court reasoned that under New York law, imposition of punitive damages is a power reserved to the state and its courts and the Federal Arbitration Act (FAA) does not preempt a New York choice-of-law provision.<sup>11</sup> The decision was affirmed by the Seventh Circuit Court of Appeals which reasoned that the parties, by agreeing to arbitrate all of the controversies under New York law without excluding the arbitration rules, had adopted the Garrity Rule as binding on their contract.<sup>12</sup> The Seventh Circuit concluded that while the FAA requires courts to favor arbitration, this federal policy does not stand for "arbitration per se" and would not preclude enforcement of an agreement not to arbitrate certain claims.<sup>13</sup>

The United States Supreme Court reversed the district and appellate courts. The main issue before the Court was whether the arbitrators' award of punitive damages was consistent with the central purpose of the Federal Arbitration Act to ensure "that private agreements to arbitrate are enforced according to their terms."<sup>14</sup> *Held*: If contracting parties agree to include claims for punitive

5. 9 U.S.C. § 3 (1925) states in relevant part:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which suit is pending . . . shall . . . stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement . . . .

6. 9 U.S.C. § 4 (1925) states in relevant part:

A party aggrieved by the alleged failure . . . of another to arbitrate under a written agreement for arbitration may petition any court of the United States which, save for such agreement, would have jurisdiction . . . for an order directing that such arbitration proceed in the manner provided for in such agreement . . . .

7. *Mastrobuono*, 115 S. Ct. at 1215.

8. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 812 F. Supp. 845 (N.D. Ill. 1993), *aff'd*, 20 F.3d 713 (7th Cir. 1994), and *rev'd*, 115 S. Ct. 1212 (1995).

9. 489 U.S. 468, 109 S. Ct. 1248 (1989) (discussed *infra* part II).

10. *Mastrobuono*, 812 F. Supp. at 847.

11. *Id.* at 847.

12. 20 F.3d 713, 717 (7th Cir. 1994), *rev'd*, 115 S. Ct. 1212 (1995).

13. 20 F.3d at 719; *see also infra* part II.

14. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1213 (1995) (quoting *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479, 109 S. Ct. 1248, 1255-56 (1989)).

damages within the issues to be arbitrated, the FAA ensures that their agreement will be enforced according to its terms even if a state law rule would otherwise exclude such claims from arbitration.<sup>15</sup>

## II. THE LAW PRIOR TO *MASTROBUONO*

### A. Introduction

Arbitration, a form of alternative dispute resolution, is increasingly common in today's fast-paced commercial world. Arbitration is faster and more efficient than the overcrowded traditional judicial tribunals. It has become especially important in the investment business as arbitration clauses are standard in client agreements. Arbitration is a matter of contract and both parties to a dispute must agree to submit to it. Courts look at the arbitration agreement to determine the scope of arbitration. Few arbitration agreements expressly contemplate punitive damages.<sup>16</sup> Therefore, most courts look first to the whole of the arbitration agreement for clues as to the parties' intent and, second, to the rules of the arbitration forum. While only two percent of claims submitted to arbitration result in punitive damages,<sup>17</sup> punitive damage awards can result in a substantial increase in the cost of litigation. Therefore, many brokerage firms are concerned with the current trend favoring these awards.

This note will focus on the Court's analysis in *Mastrobuono*. This note will also focus on the legislative and judicial history of arbitration, the Federal Arbitration Act and securities agreements with arbitration clauses. In conclusion, this note will analyze the current problems posed by *Mastrobuono* and recent developments in securities law.

### B. The Federal Arbitration Act

The United States Supreme Court cases of the 1980s concerning securities arbitration are based in large part on the Federal Arbitration Act.<sup>18</sup> Section 2 of the Act provides:

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*

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15. *Id.* at 1219.

16. Carroll E. Neeseaman & Maren E. Nelson, *Damages, in Securities Arbitration 1995*, at 417 (PLI No. 900, 1995).

17. *Punitive Award Survey*, Sec. Arb. Commentator, May 1993, at 1, 7.

18. 9 U.S.C. §§ 1-15 (1925).

*enforceable*, save upon such grounds as exist at law or in equity for the revocation of any contract.<sup>19</sup>

The legislative intent behind the FAA is to place an arbitration agreement "upon the same footing as other contracts."<sup>20</sup> The Act was considered necessary by Congress because courts were hostile toward the concept of alternative forms of dispute resolution. The House Report accompanying the bill for the Federal Arbitration Act states:

The need for the law arises from . . . the jealousy of the English courts for their own jurisdiction . . . . This jealousy survived for so long [sic] a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment . . . .<sup>21</sup>

Most of the issues faced by the Supreme Court concerning arbitration after the enactment of the FAA have involved the scope of the Act. Also at issue has been the power of the states and the contracting parties to limit and expand controversies under arbitration.

### C. *The Supreme Court Decisions*

To understand the significance of the *Mastrobuono* decision, it is first necessary to review the Supreme Court cases decided since the enactment of the FAA. The cases build upon each other. Therefore, this note will examine these cases chronologically.

The first case, *Wilko v. Swan*,<sup>22</sup> interpreted the FAA narrowly. The Court in *Wilko* held the right to a judicial forum provided by the Securities Act of 1933 cannot validly be waived through a predispute arbitration agreement.<sup>23</sup> The Court recognized that the general purpose of the FAA is to give arbitration participants an opportunity to secure prompt, economical and adequate solutions of controversies through arbitration "if the parties are willing to accept less certainty of legally correct adjustment,"<sup>24</sup> but saw a conflict between the arbitration clause in the contract and a Securities Act provision that nullified contractual waivers of Securities Act rights. The Court held that rights to a judicial forum were among the rights that could not be waived. The Court explained:

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19. 9 U.S.C. § 2 (1925) (emphasis added).

20. H.R. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924).

21. *Id.*

22. 346 U.S. 427, 438, 74 S. Ct. 182, 188 (1953).

23. *Id.* at 435, 74 S. Ct. at 186.

24. *Id.* at 438, 74 S. Ct. at 188 (emphasis added).

When the security buyer, prior to any violation of the Securities Act, waives his right to sue in courts, he gives up more than would a participant in other business transactions. The security buyer has a wider choice of courts and venue. He thus surrenders one of the advantages the Act gives him and surrenders it at a time when he is less able to judge the weight of the handicap the Securities Act places upon his adversary.<sup>25</sup>

The Court concluded that while predispute arbitration agreements may provide advantages such as efficiency, the intention of Congress concerning the sale of securities was better served by holding invalid a predispute agreement compelling arbitration.

*Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*<sup>26</sup> marked the beginning of a much broader reading of the FAA. In *Moses*, the Court held:

The Arbitration Act establishes that, as a matter of federal law, 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.<sup>27</sup>

The Court stated the FAA established a "federal substantive law" of arbitrability under § 2 of the FAA.<sup>28</sup> The Court saw Section 2 as a strong indication of Congress' intent to foster a liberal policy favoring arbitration agreements, applicable to any arbitration agreement within the coverage of the Act.<sup>29</sup> The Court held the FAA applies to any arbitration agreement within the coverage of the act.<sup>30</sup> This holding was the Court's first pronouncement that state courts should follow the FAA.

In *Southland Corp. v. Keating*,<sup>31</sup> the Court held the FAA went further than declaring a national policy favoring arbitration and actually withdrew the states' power to require a judicial forum for the resolution of claims if the contracting parties had agreed to arbitration.<sup>32</sup> A provision of the California Franchise Investment Law,<sup>33</sup> invalidating certain arbitration agreements covered by the

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25. *Id.* at 435, 74 S. Ct. at 187.

26. 460 U.S. 1, 103 S. Ct. 927 (1983).

27. *Id.* at 24-25, 103 S. Ct. at 941.

28. *Id.* at 24, 103 S. Ct. at 941.

29. *Id.*

30. *Id.* at 24, 103 S. Ct. at 941.

31. 465 U.S. 1, 104 S. Ct. 852 (1984).

32. *Id.*

33. Cal. Corp. Code § 31512 (West 1977) states: "[a]ny condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void."

FAA, was held to violate the Supremacy Clause because the FAA embodied substantive federal law applicable in state as well as federal courts. According to *Southland*, Congress intended the FAA to foreclose state legislative attempts to undercut the enforceability of arbitration agreements.<sup>34</sup> Justice O'Connor argued in her dissent that the FAA is only a matter of federal procedural law.<sup>35</sup> However, her view was (and still is) in the minority. By the end of the 1980s, it was well established that the FAA contained federal substantive law which preempted any conflicting state law.

As another example of the Court's willingness to favor arbitration, the Court in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*<sup>36</sup> held agreements to arbitrate should be generously construed.<sup>37</sup> A contract clause binding the parties to settle all disputes through arbitration conducted according to rules which allow any form of just and equitable remedy of relief is sufficiently broad enough to encompass the awarding of punitive damages.<sup>38</sup> The Court reasoned, "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."<sup>39</sup>

The Supreme Court distinguished the *Wilko* Court's reluctance to enforce arbitration agreements in *Shearson/American Express, Inc. v. McMahon*.<sup>40</sup> The Court made it clear that federal securities claims may be arbitrated and that arbitration is the favored method for resolving these disputes. The *McMahon* court approved arbitration as a means of resolving claims under the Securities Exchange Act of 1934 and the Racketeer Influenced Corrupt Organizations Act.<sup>41</sup> In distinguishing *Wilko*, the *McMahon* Court stated, "the plaintiff's waiver of the right to select the judicial forum . . . was unenforceable only because arbitration was judged inadequate to enforce the substantive and statutory rights created by [the Securities Act]."<sup>42</sup> The *McMahon* Court reasoned the FAA's mandate that agreements to arbitrate statutory claims be enforced may be overridden by contrary congressional command. However, the burden is on the party opposing the arbitration to show that Congress intended to preclude waiver of judicial remedies for statutory rights at issue. Such intent is deducible from the statute's text or legislative history or from inherent conflict between arbitration and the statute's underlying purpose.<sup>43</sup> The Court searched the statutes for evidence of Congressional intent to require a judicial forum for

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34. 465 U.S. at 16, 104 S. Ct. at 861.

35. *Id.* at 25, 104 S. Ct. at 864 (O'Connor, J., dissenting).

36. 473 U.S. 614, 105 S. Ct. 3346 (1985).

37. *Id.* at 626, 105 S. Ct. at 3354.

38. *Id.*

39. *Id.* at 628, 105 S. Ct. at 3354.

40. 482 U.S. 220, 107 S. Ct. 2332 (1987).

41. *Id.*

42. *Id.* at 229, 107 S. Ct. at 2338-39.

43. *Id.* at 227, 107 S. Ct. at 2337-38.

the resolution of claims but it could not find any such evidence. Therefore, the Court upheld the arbitration agreement under R.I.C.O. and the Exchange Act. However, the Court left open the question whether *Wilko* itself should be overruled. The Court answered the question in *Rodríguez de Quijas v. Shearson/American Express, Inc.*<sup>44</sup> In this 5-4 decision, the Court expressly overruled *Wilko v. Swan* and held arbitration could be compelled under the Securities Act just as it could be under R.I.C.O. and the Exchange Act.<sup>45</sup> *Rodríguez* is clear evidence of the United States Supreme Court's current pro-arbitration policy, and its repudiation of its initial hostility toward the FAA.

The only exception to the pro-arbitration policy of the post-*Wilko* Supreme Court cases is *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*.<sup>46</sup> *Volt* permitted California law<sup>47</sup> to stay an arbitration proceeding pending resolution of related litigation between a party to the arbitration agreement and a third party who was not bound to arbitrate. The Court allowed the anti-arbitration effect of the California law to stand because the parties to the arbitration agreement had explicitly agreed that California law would govern their disputes. The Court restated that the principal policy of the FAA is to enforce private arbitration agreements in accordance with their terms, including their choice-of-law terms, but concluded there is no federal policy favoring arbitration under a certain set of procedural rules.<sup>48</sup>

Recently, however, the Court in *Allied-Bruce Terminix Cos. v. Dobson*<sup>49</sup> returned to a broader reading of the FAA. The *Allied-Bruce* Court upheld the enforceability of a pre-dispute arbitration agreement governed by Alabama law, even though an Alabama statute provided that arbitration agreements were unenforceable.<sup>50</sup> Many of the state attorney generals asked the Court in *Allied-Bruce* to overrule the *Southland* preemption rule and to allow states to enact anti-

44. 490 U.S. 477, 109 S. Ct. 1917 (1989).

45. *Id.* at 480-81, 109 S. Ct. at 1920.

46. 489 U.S. 468, 109 S. Ct. 1248 (1989).

47. The California Arbitration Act, Cal. Civ. Proc. Code § 1281.2(c) (West 1982) provides in pertinent part:

[When a court determines that a] party to the arbitration agreement is also a party to a pending court action . . . with a third party, arising out of the same transaction . . . and there is a possibility of conflicting rulings on a common issue of law or fact[,] . . . the court (1) may refuse to enforce the arbitration agreement and may order intervention or joinder of all parties in a single action or special proceeding; (2) may order intervention or joinder as to all or only certain issues; (3) may order arbitration among the parties who have agreed to arbitration and *stay the pending court action . . . pending the outcome of the arbitration proceeding*; or (4) *may stay arbitration pending the outcome of the court action or special proceeding.*

(emphasis added).

48. 489 U.S. at 476, 109 S. Ct. at 1254.

49. 115 S. Ct. 834 (1995).

50. *Id.* at 836; Ala. Code § 8-1-41(3) (1993) makes written, predispute arbitration agreements invalid and unenforceable.

arbitration statutes. The Court refused and concluded that the purpose of the FAA is to overrule courts' refusals to enforce arbitration agreements.<sup>51</sup>

The question facing the Court was the scope of § 2 of the FAA, specifically the words "involving commerce." The Court concluded the word "involving" is broad enough and is indeed the functional equivalent of "affecting" and, therefore, signals an intent by Congress to exercise Congress' commerce power to the fullest.<sup>52</sup> In conclusion, the Court stated:

States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause "upon such grounds as exist at law or in equity for the revocation of *any* contract." What States may not do is decide that a contract is fair enough to enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause. The Act makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal "footing," directly contrary to the Act's language and Congress's intent.<sup>53</sup>

This statement by the Court means that the states cannot restrict parties' ability to arbitrate except under rules applicable to contracts generally. Therefore, when parties include an arbitration provision in their contract, the courts cannot strike the arbitration provision down while upholding the remaining terms merely because a state law prohibits or restricts arbitration.

Due to the Court's willingness to favor arbitration, many brokerage houses attempted to find ways to circumvent arbitral punitive damages awards. One such technique was to use a New York choice-of-law clause. The Garrity Rule<sup>54</sup> had become very common in the client agreements used by most brokerage firms (including the one in *Mastrobuono* itself) and appeared to be enforceable under the ruling in *Volt*.

#### *D. The Split Among the Courts of Appeals Over Choice-of-Law Provisions and Punitive Damages*

Before the decision in *Mastrobuono*, the Second and the Seventh Circuits held that a choice-of-law provision could preclude an arbitral award of punitive damages that would otherwise be proper. The Second Circuit held the Garrity Rule barred any award of punitive damages.<sup>55</sup> The Second Circuit relied on *Volt* and reasoned that a New York choice-of-law clause in an arbitration

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51. *Allied-Bruce*, 115 S. Ct. at 838.

52. *Id.* at 841.

53. 115 S. Ct. at 843 (quoting 9 U.S.C. § 2 (1925)) (emphasis in original).

54. *See supra* note 2.

55. *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2d Cir. 1991); New York, founder of the Garrity Rule, sits in the Second Circuit.

agreement is an agreement to incorporate all of New York law, including the Garrity Rule barring punitive damages, and thus, the arbitration panel is precluded from awarding punitive damages.<sup>56</sup> The arbitration agreement in *Barbier* was virtually identical to the one in *Mastrobuono*. The Second Circuit even held that a federal court sitting in diversity jurisdiction should apply the Garrity Rule without a choice-of-law clause, unless the parties' agreement expressly provided for punitive damages.<sup>57</sup> While the Seventh Circuit did not go quite as far as the Second, the Seventh held that a New York choice-of-law clause precluded an award of punitive damages.<sup>58</sup>

In contrast to the Second and Seventh Circuits, the majority of the circuits concluded that choice-of-law provisions did not preclude an otherwise proper award of punitive damages.<sup>59</sup> Those appellate courts reasoned that the incorporation of a New York choice-of-law clause merely meant the arbitrators were to use New York substantive law to determine whether the actions would warrant an award of punitive damages.<sup>60</sup> The power to award those damages was deemed procedural and so was not incorporated into a contract with a New York choice-of-law clause.<sup>61</sup> The anti-*Garrity* courts allowed punitive damages where the parties had adopted the American Arbitration Association's (AAA) rules. The courts reasoned that AAA Rule 43<sup>62</sup> specifically allowed arbitrators to award any relief that the arbitrator deemed just and equitable, including an award of punitive damages.

### III. THE COURT'S REASONING IN *MASTROBUONO*

The majority in *Mastrobuono* recognized that Congress passed the FAA to overcome courts' refusals to enforce agreements to arbitrate.<sup>63</sup> The Court said, "[i]f contracting parties agree to include claims for punitive damages within the issues to be arbitrated, the FAA ensures that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such

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56. *Id.* at 121.

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

58. *See Pierson v. Dean, Witter, Reynolds, Inc.*, 742 F.2d 334 (7th Cir. 1984); *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638 (7th Cir. 1981); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith*, 558 F.2d 831 (7th Cir. 1977).

59. *See Lee v. Chica*, 983 F.2d 883 (8th Cir. 1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991); *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).

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

61. *Id.* at 1387.

62. Rule 43 of the American Arbitration Association, Securities Arbitration Rules (1989) provides the arbitrator with the authority to "grant any remedy or relief that the arbitrator deems just and equitable, including but not limited to, specific performance of a contract." The AAA is an independent arbitration association that can hear all types of claims. However, most brokerage firms require claims to be arbitrated according to the NASD, AMEX, or NYSE Rules.

63. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1215 (1995).

claims from arbitration.”<sup>64</sup> Therefore, the Court reasoned, the case came down to what the contract said about the arbitrability of Mastrobuono’s punitive damages claim.<sup>65</sup>

The Court first looked at the standard-form Client Agreement. The two relevant sections were: 1) that the entire agreement was governed by the laws of the State of New York and 2) that any controversy arising out of the transactions between the parties would be settled by arbitration in accordance with the rules of the National Association of Securities Dealers (NASD), the Board of Directors for the New York Stock Exchange, and/or the American Stock Exchange. The agreement contained no express reference to punitive damages.<sup>66</sup>

The Supreme Court followed the majority of the circuit courts and determined that the choice-of-law provision was either a substitute for the conflict of laws analysis or that the clause included only New York’s substantive rights and obligations, and not the state’s allocation of power between courts and arbitrators.<sup>67</sup> The Court interpreted the arbitration provision as broad enough to contemplate an award of punitive damages because the NASD’s Code of Arbitration Procedure indicates that arbitrators may award “damages and other relief.”<sup>68</sup> The majority felt the provision of the NASD was sufficiently broad to at least contemplate an award of punitive damages.<sup>69</sup>

The Court read the arbitration and choice-of-law clauses *in pari materia* and reasoned the choice-of-law clause merely introduced an ambiguity into an arbitration agreement that would otherwise allow punitive damages.<sup>70</sup> When a court interprets such provisions in an agreement covered by the FAA, said the Court, due regard must be given to the federal policy favoring arbitration.<sup>71</sup> The Court backed up its reasoning with the common-law contract interpretation principle that a court should construe ambiguous language against the drafting party. The majority determined the best way to harmonize the choice-of-law provision was to read “the laws of the State of New York” to encompass the substantive principles New York courts would apply, but not to include special rules limiting the authority of arbitrators.<sup>72</sup> The choice-of-law provision covered the rights and duties of the parties, while the arbitration clause covered arbitration. Therefore, the Court concluded the choice of law provision and the arbitration clause were independent: neither one affected the other.

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64. *Id.*

65. *Id.*

66. Neeseman & Nelson, *supra* note 16.

67. *Mastrobuono*, 115 S. Ct. at 1216.

68. *Id.* at 1217; NASD Code of Arbitration Procedure § 3741(e) (1993).

69. *Mastrobuono*, 115 S. Ct. at 1217.

70. *Id.* at 1218.

71. *Id.*

72. *Id.*

The Court explained that a New York choice-of-law provision in the agreement "is not, in itself, an unequivocal exclusion of punitive damages."<sup>73</sup> The Court admitted there were several ways in which this contract could be read, including one disallowing punitive damages. However, the Court chose to read the contract to allow punitive damages in the wake of the FAA's pro-arbitration goals.

Justice Thomas contended in his dissent that the choice-of-law provision that had been disregarded in *Mastrobuono* was indistinguishable from the provision that had been enforced in *Volt*.<sup>74</sup> Justice Thomas reemphasized the *Volt* principle that an agreement to arbitrate had to be enforced according to the terms provided by the parties.<sup>75</sup> Justice Thomas stated, "[t]here is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate."<sup>76</sup>

Justice Thomas compared the two cases and noted that both parties agreed to mandatory arbitration of all disputes.<sup>77</sup> He also noted that the only difference between the two clauses was the state specified. Otherwise, the clauses were the same. The clause in *Volt* specified California law while the one at issue in *Mastrobuono* specified New York law.

Justice Thomas criticized the majority for holding that the incorporation of New York law did not need to be read so broadly as to include both substantive and procedural law. He pointed out that this same argument had been rejected in *Volt*. Justice Thomas also disagreed with the majority's determination that the NASD rules provide for punitive damages. The NASD Code of Arbitration Procedure states:

The award shall contain the names of the parties, the name of counsel, if any, a summary of the issues, including the type(s) of any security or product, in controversy, the damages and other relief requested, the damages and other relief awarded, a statement of any other issues resolved, the names of the arbitrators, the dates the claim was filed and the award rendered, the number and dates of hearing sessions, the location of the hearings, and the signatures of the arbitrators concurring in the award.<sup>78</sup>

Justice Thomas stated, "it is clear that [§] 41(e) does not define or limit the power of arbitrators; it merely describes the form in which the arbitrators must

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73. *Id.* at 1216.

74. *Id.* at 1219 (Thomas, J., dissenting); *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 109 S. Ct. 1248 (1989).

75. *Id.* at 1219 (Thomas, J., dissenting).

76. *Id.* at 1219 (Thomas, J., dissenting) (quoting *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 109 S. Ct. 1248 (1989)).

77. *Id.* at 1220 (Thomas, J., dissenting).

78. NASD Code of Arbitration Procedure § 41(e) (1985).

announce their decision."<sup>79</sup> He reasoned the other provisions of § 41 confirm the point. The examples he gave were § 41(a), which provides that all awards shall be in writing and signed by a majority of the arbitrators, and § 41(c), which provides that the Director of Arbitration shall endeavor to serve a copy of the award to the parties. Justice Thomas pointed out that the majority could not find a provision of the NASD Code that specifically addressed punitive damages or that spoke more generally to the types of damages arbitrators may or may not allow. "The Code certainly does not require that arbitrators be empowered to award punitive damages; it leaves to the parties to define the arbitrators' remedial powers."<sup>80</sup> Justice Thomas limited the holding of *Mastrobuono* to its specific facts. He stated:

This case amounts to nothing more than a federal court applying Illinois and New York contract law to an agreement between parties in Illinois . . . . [T]he majority's interpretation . . . represents only the understanding of a single federal court regarding the requirements imposed by state law. [T]he majority's opinion has applicability only to this specific contract and to no other.<sup>81</sup>

#### IV. ANALYSIS OF *MASTROBUONO*

##### A. Subsequent Case Law

Federal courts, including the former pro-Garrity Second and Seventh Circuits, are freely accepting the *Mastrobuono* holding.<sup>82</sup> The district court for the Southern District of Indiana summed up the way courts are reading *Mastrobuono*. In *Shearson Lehman Brothers, Inc. v. Neurosurgical Associates of Indiana*,<sup>83</sup> the court stated:

Prior to *Mastrobuono*, if an arbitration dispute was governed by New York law, the arbitrators were precluded from awarding punitive damages pursuant to the rule set forth in *Garrity v. Lyle Stuart*. . . .

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79. *Mastrobuono*, 115 S. Ct. at 1220 (Thomas, J., dissenting).

80. *Id.* at 1221 (Thomas, J., dissenting).

81. *Id.* at 1223 (Thomas, J., dissenting).

82. The Second and Seventh Circuits had previously held that New York choice-of-law clauses bar punitive damage awards through arbitration. See *supra* Section II.D and *Painewebber, Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996) (a choice-of-law provision will not be construed to impose substantive restrictions on the parties' rights under the FAA, including the right to arbitrate claims for attorney's fees); *Smith Barney, Inc. v. Schell*, 53 F.3d 807 (7th Cir. 1995) (punitive damages were available where the arbitration agreement was identical to the one in *Mastrobuono*); *Merrill Lynch, Pierce, Fenner & Smith v. Masland*, 878 F. Supp. 710 (M.D. Penn. 1995) (New York law was inapplicable to the issue of arbitrability under *Mastrobuono* because the contract language of the agreement is preempted by the FAA); *PaineWebber v. Richardson*, 1995 WL 236722 (S.D.N.Y. 1995).

83. 896 F. Supp. 844 (S.D. Ind. 1995).

The Seventh Circuit applied the Garrity Rule if the agreement to arbitrate had a choice-of-law provision selecting New York law. . . . The Supreme Court overruled the Seventh Circuit in *Mastrobuono* and held that choice-of-law provisions in arbitration agreements that reference New York law . . . cover[s] the rights and duties of the parties, while the arbitration clause covers arbitration.<sup>84</sup>

In contrast to the Second and Seventh Circuits, the Fifth Circuit does not read *Mastrobuono* as expansively. In *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*,<sup>85</sup> the court reversed an arbitrator's award of punitive damages. The parties explicitly agreed that Virginia law would control any dispute;<sup>86</sup> Virginia law does not allow a court to award punitive damages for breach of contract.<sup>87</sup> The court then held that the award of punitive damages was contrary to Virginia law. Similarly, Louisiana does not allow punitive damages for breach of contract.<sup>88</sup>

But while the majority of the federal courts are following *Mastrobuono*, the New York state courts may not be. One recent New York case held that New York law—specifying clauses operate to prohibit the award of punitive damages in the underlying arbitration.<sup>89</sup> The court distinguished *Mastrobuono* by reasoning that *Mastrobuono* involved strong policy concerns: protecting the client who may not realize he is waiving a punitive damages claim. The court in *Trimble* noted that the plaintiff in this case was represented by counsel and voluntarily elected to pursue arbitration under AMEX rules and should not have been surprised by the law of the jurisdiction. The court reasoned the fairness concern for uninformed claimants was absent and ruled that the strong public policy of the State of New York against punitive damages in arbitration was paramount.<sup>90</sup>

### B. Effect on Prior Law

The holding of *Mastrobuono* is more far reaching than Justice Thomas contends in his sole dissent.<sup>91</sup> Justice Thomas concluded that the holding of the

84. *Id.* at 847; for more recent cases following *Mastrobuono*, see also *Davis v. Prudential Sec.*, 59 F.3d 1186 (11th Cir. 1985); *Kelley v. Michaels*, 59 F.3d 1050 (10th Cir. 1995).

85. 64 F.3d 993, 999 (5th Cir. 1995).

86. *Id.* at 999.

87. *Id.* at 999. See also *Gasque v. Mooers Motor Car Co., Inc.*, 227 Va. 154, 159, 313 S.E.2d 384, 388 (1984) (punitive damages must be predicated on tort liability).

88. Under Louisiana law, punitive damages are only allowed for damages caused to a minor for sexual abuse and damages caused by a drunk driving accident.

89. *Dean Witter Reynolds, Inc. v. Trimble*, 631 N.Y.S. 2d 215 (New York County, 1995); *cf. In re Prudential Securities*, 642 N.Y.S. 2d 466 (New York County, 1995) (court reads *Mastrobuono* as controlling when there is a New York choice-of-law clause in the arbitration agreement).

90. 6 World Arb. & Mediation Rep. 179 (1995).

91. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1222 (1995) (Thomas, J., dissenting).

majority "represents only the understanding of a single federal court regarding the requirements imposed by state law. As such, the majority's opinion has applicability only to this specific contract and to no other."<sup>92</sup> The reasoning in *Volt* may now be limited to its facts. The *Volt* court had used a choice-of-law clause to limit, indirectly, the parties' rights to arbitration.<sup>93</sup> *Mastrobuono* found a similarly indirect limitation too ambiguous to overcome the federal policy in favor of arbitration. Unlike *Volt*, however, the effect of the choice-of-law provision in *Mastrobuono* was to limit the parties substantive rights in the arbitration, and not merely the timing of the arbitration as in *Volt*. Perhaps minor procedural matters may continue to be subject to *Volt*-like choice-of-law rules.

Moreover, at least in federal court, the Garrity Rule now appears to be completely preempted by the FAA and, consequently, useless as a contract clause to limit punitive damages. Because so many securities contracts contain identical arbitration and New York choice-of-law clauses, the *Mastrobuono* opinion has a far reaching impact. This impact is evident in the recent cases<sup>94</sup> following *Mastrobuono* as well as other recent developments in securities law.<sup>95</sup>

### C. New Rules

In 1989, the rules of the NYSE, the AMEX, and the NASD were revised to state that the member organizations could not use pre-dispute arbitration agreements to limit the ability of arbitrators to make any award, including punitive damages.<sup>96</sup> The SEC has approved these revised rules and construed them to prohibit brokers from attempting to limit a customer's right to seek and an arbitrator's right to award punitive damages. On March 22, 1995, the NASD issued a notice to members stating customer agreements that bar punitive damages violate Rule 21(f)(4).<sup>97</sup> Therefore, the holding of *Mastrobuono* only reinforces other mechanisms that allow arbitrators to award punitive damages.

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92. *Id.* at 1222 (Thomas, J., dissenting).

93. *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 109 S. Ct. 1248 (1989).

94. See *Davis v. Prudential Sec.*, 59 F.3d 1186 (11th Cir. 1995); *Kelley v. Michaels*, 59 F.3d 1050 (10th Cir. 1995); *Smith Barney, Inc. v. Schell*, 53 F.3d 807 (7th Cir. 1995); *Shearson Lehman Bros., Inc. v. Neurosurgical Assoc. of Ind.*, 896 F. Supp. 844 (S.D. Ind. 1995); *Merrill Lynch, Pierce, Fenner & Smith v. Masland*, 878 F. Supp. 710 (M.D. Penn. 1995); *PaineWebber v. Richardson*, 1995 WL 236722 (S.D.N.Y. 1995).

95. NASD Rule 21 (f)(4) and the recent proposals by the NASD, see *infra* Section IV.C.

96. These organizations are self-regulatory organizations (SRO's). They are responsible for overseeing the conduct of the brokerage firms. Each has its own rules of conduct for the member firms.

97. National Ass'n of Sec. Dealers, Inc., Rules of Fair Practice Rule 21(f)(4), in NASD Sec. Dealers Manual (CCH) P2171 (1994); see also New York Stock Exch., Inc., Arbitration Rules Rule 636(d), in N.Y.S.E. Guide (CCH) P2636(d) (1995).

Additional safeguards against excessive or unwarranted awards may soon be in place. In July 1994, the NASD released a report proposing several recommendations for handling punitive damages awards in arbitration.<sup>98</sup> Some of the proposals are as follows:

- 1) punitive damage awards should set forth the legal standard applied in awarding such damages, and the facts arbitrators found to justify such an award;
- 2) decisions awarding (but not denying) punitive damages should be appealable;
- 3) arbitrators' qualifications and training should be further enhanced;
- 4) scienter required for award of punitive damages should be standardized;
- 5) punitive damages portion of arbitration should be bifurcated from the remainder of arbitration proceeding;
- 6) caps on punitive damages should be adopted; and
- 7) punitive awards should be shared with state, federal, or quasi-governmental regulators.

However, the NASD has taken no formal action on these proposals since their release.<sup>99</sup>

#### *D. Limited Review of Arbitration Decisions*

One reason why many commentators are upset over the *Mastrobuono* decision is the limited judicial review of arbitration awards including punitive damages.<sup>100</sup> Arbitrators's unbridled discretion in awarding punitive damages causes concern.

Recent due process decisions on the issue of punitive damages in general complicate the problem of arbitration discretion.<sup>101</sup> Recently, the Supreme Court held "a mathematical bright line cannot be drawn between the constitutionally acceptable and the constitutionally unacceptable"<sup>102</sup> level of punitive damages. The Court upheld a \$1 million award of punitive damages (more than four times the amount of compensatory damages) as justified because it was based on objective criteria and was subject to procedural protections including appropriate jury instructions, a post-verdict hearing, and state supreme court

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98. Neeseman & Nelson, *supra* note 16.

99. *Id.*

100. Carroll E. Neeseman, Maren E. Nelson, *Securities Arbitration § 1995: Securities Arbitration Damages*, 900 PLI/Corp. 417 (1995); Constantine N. Katosoris, John F.X. Peloso, *New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 63 *Fordham L. Rev.* 1571 (1995).

101. *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 111 S. Ct. 1032 (1991); *Honda Motor Co. v. Oberg*, 114 S. Ct. 2331 (1994).

102. *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 111 S. Ct. 1032 (1991).

review.<sup>103</sup> In non-arbitration context, the Supreme Court has held that due process requires judicial review of the size of punitive damage awards.<sup>104</sup> The test adopted by the Supreme Court is a "general concern of reasonableness" to determine whether a punitive damage award is "grossly excessive."<sup>105</sup>

It is disturbing that the courts of appeals and district courts do not have a similar test to review arbitration awards. Lack of a review standard is especially problematic since the arbitrators are not required to issue reasons accompanying an award of punitive damages, and failure to issue reasons is not reason to vacate an award.<sup>106</sup> Also, the judicial review of decisions of arbitrators is limited to the reasons set forth in § 10 of the FAA. Section 10 provides, in pertinent part:

- 1) Where the award was procured by corruption, fraud, or undue means.
- 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 exceed their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter was not made.<sup>107</sup>

Limited review is necessary if arbitration is to serve as a quick, inexpensive and informal means of dispute resolution.<sup>108</sup> The interesting question that *Mastrobuono* left unanswered is whether punitive damage arbitration awards will be subject to greater scrutiny than other compensatory awards. Although punitive damage awards in connection with securities agreements are limited to rare instances of gross negligence or intentional misconduct, many brokerage houses remain very concerned.

A recent United States Supreme Court case, *First Options of Chicago, Inc. v. Kaplan*,<sup>109</sup> held that if parties to arbitration agreed to submit the arbitrability question itself to arbitration, the court's standard for reviewing the arbitrator's decision as to arbitrability is the same as reviewing any other matter that parties have agreed to arbitrate.<sup>110</sup> The appropriate standard is to give considerable leeway to the arbitrator and set aside his decision only in certain, narrow

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103. *Id.* at 111.

104. *Honda Motor Co. v. Oberg*, 114 S. Ct. 2331 (1994).

105. *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711 (1993).

106. *Edward's & Son's, Inc. v. McCollough*, 967 F.2d 1401 (9th Cir. 1992).

107. 9 U.S.C. § 10(a) (1994).

108. Carroll E. Neeseman & Maren E. Nelson, *Securities Arbitration 1995: The Law of Securities Arbitration*, 899 PLI/Corp. 135, 162 (July-August 1995).

109. 115 S. Ct. 1920 (1995).

110. *Id.* at 1924.

circumstances.<sup>111</sup> Thus, even after the *Mastrobuono* decision, the Court has refused to expand judicial review of arbitration decisions.

It will be interesting to see if there will be a significant increase in the number of punitive damages awards in the wake of *Mastrobuono*. This is a concern because commentators and courts are reading *Mastrobuono* to mean that punitive damages are an appropriate remedy.<sup>112</sup> However, *Mastrobuono* did not say this. The holding was that if the parties clearly contemplated that punitive damage awards could be awarded, the court is to enforce the contract according to its terms.

Brokerage houses may change their standard-form client agreements and omit arbitration completely. As discussed earlier, arbitration is solely a matter of contract. Therefore, if the brokerage houses do not include an arbitration clause, they cannot be subject to arbitration. Fewer arbitration clauses could result in fewer claims against these brokerage houses because many clients cannot afford the significant costs of litigation. Therefore, the holding of *Mastrobuono* could do the opposite of what the Court intended. It could result in fewer parties using arbitration, frustrating the FAA's goals of encouraging arbitration. However, it is unlikely that securities firms will omit arbitration clauses entirely from their client agreements when only a small percentage of claims end in an award of punitive damages.

#### E. Conclusion

The full ramifications of the *Mastrobuono* holding may not be seen for some time. The Supreme Court, NASD, AMEX, and NYSE have all laid the foundation to encourage arbitrators to award punitive damages. These organizations base their rulings on the policy of helping the clients who have no control in the wording of the client agreements they sign. This is in sharp contrast to *Volt* where the Court based the holding on enforcing the arbitration agreement according to the terms of the agreement. Protecting the consumer is a valid policy concern; the Court is moving in the right direction by allowing punitive damages. However, the Court should not swim in these treacherous waters without establishing some guidelines on how to keep a tight reign on punitive damage awards. What *Mastrobuono* left unanswered is how the Court and the securities industry are supposed to respond. Will the Court now impose a higher degree of judicial review on punitive damage awards? Will the industry establish standards justifying such awards? Will the policy of protecting the "weaker party" spread into other areas of arbitration? Only time will tell. Until then, the brokerage firms must ponder a future in the uncertain world of punitive damages.

*Virginia Trainor*

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111. *Id.* at 1922; the certain and narrow circumstances are set forth in § 10 of the FAA discussed *supra*.

112. Neeseman & Nelson, *supra* note 16, at 429. *See supra* note 82.

