

PUNITIVE DAMAGES IN SECURITIES ARBITRATION AFTER 'MASTROBUONO'

by: Harry S. Miller



In a landmark victory for investors and a major setback for stock brokerage firms, the U.S. Supreme Court recently ruled that arbitrators may award punitive damages in securities arbitration. *Mastrobuono, et. al. v. Shearson Lehman Hutton, Inc., et. al.*, 1995 WL 86555.

Previously, this had been an area of controversy in light of 1st Circuit authority in Massachusetts which supported the power of arbitrators to award punitive damages while New York law (which generally controls broker/customer disputes) prohibited such arbitration awards.

As Congress demanded limits on securities investors' recourse to the judicial system, the Supreme Court moved in the opposite direction in *Mastrobuono*, supporting the right of investors to an extremely potent weapon in the battle against securities fraud.

The 8-1 Supreme Court decision held that brokerage firms may not rely upon standard choice-of-law arbitration provisions in customer agreements to preclude punitive damages in the face of the broad public policies of the Federal Arbitration Act and the rules of the National Association of Securities Dealers (NASD).

Individual public investors involved in customer/stockbroker disputes file approximately 5,000 securities arbitration cases with the NASD nationally each year. A smaller number of securities cases are filed with the New York Stock Exchange arbitration forum and the American Arbitration Association. Claims filed by local customers are arbitrated in Massachusetts for all three forums.

Many of these customer-broker disputes involve claims of misrepresentations, fraud, unauthorized trading, churning (excessive trading for the purpose of generating commissions, and unsuitability (inappropriate trading in high risk or speculative securities contrary to the customer's understanding, financial needs and investment objectives).

In the past, only a relatively small percentage of securities arbitration decisions included awards of punitive damages. This reflected the freezing effect of the now rejected New York authority which had prohibited punitive damages in arbitration.

However, merely returning ill-gotten gains or compensating for losses is not adequate. It has been recognized that damages awarded must be sufficiently large to make unlawful activity economically disadvantageous for brokerage firms. More punitive damage awards in securities arbitration are anticipated now after the Supreme Court's *Mastrobuono* decision.

The 'Mastrobuono' Case

The investors in this case, Antonio Mastrobuono, an assistant professor of medieval literature, and his wife Diana Mastrobuono, an artist, had invested with Shearson Lehman Hutton, Inc. in Chicago. They had opened their Shearson account with a standard form New Customer Agreement which included an arbitration provision, The agreement also included a choice-of-law provision which, like the vast majority of major brokerage firm forms used nationally, provided that the contract would be governed by New York law.

In 1989, the Mastrobuonos filed an action against Shearson and their broker alleging that their account had been mishandled, including through unauthorized transactions, and claimed damages on various state and federal causes of action.

A NASD arbitration panel ruled in favor of the Mastrobuonos awarding them \$159,000 in compensatory damages and \$400,000 in punitive damages. Shearson then filed a motion in federal District Court to vacate the award of

punitive damages on the grounds that under New York law, which governed the parties' agreement, the power to award punitive damages (according to New York case law) is limited to the courts and may not be exercised by arbitrators. *Garrity u. Lyle Stewart, Inc.*, 40 N.Y.2d 354, 353 N.E. 2d 793 (1976).

The District Court in *Mastrobuono* granted motion to vacate the punitive damages, 812 F. Supp. 845 (N.D. III. 1993), and the Appeals Court affirmed the rejection of arbitrators' power to award punitive damages. 20 F.3d 713 (7th Cir. 1994).

The Supreme Court granted certiorari acknowledging a conflict of authority among the circuits, including the 1st Circuit decision in the Massachusetts case of *Raytheon Co. v. Automated Business Systems, Inc.*, (discussed further below) conflicting with the 2nd Circuit New York decisions. The court's opinion authored by Justice Stevens (with Justice Thomas dissenting) reversed the vacatur, holding that the arbitration award should have been enforced, including the punitive damages, as within the scope of the contract between the parties.

Imposition of New York Rule Rejected

The Supreme Court in *Mastrobuono* acknowledged that New York law does not allow arbitrators to award punitive damages. The New York authority on that matter had been clearly pronounced in *Garrity*, supra, and by the 2nd Circuit Court of appeals in *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117 (2nd Cir. 1991).

However, the high court questioned the extent of the application of the New York choice-of-law provision, especially in the face of the central purpose of the Federal Arbitration Act (FAA), 9 U.S.C. §1 et seq., to ensure "that private agreements to arbitrate are enforced according to their terms." *Mastrobuono* quoting *Volt Information Sciences Inc. v. Board of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 479 (1989).

Shearson and the Securities Industry Association in an amicus brief argues against preemption of the New York law by the FAA relying upon *Volt*, supra, and also raised due process and policy considerations.

The S.E.C., however, in its amicus brief and oral argument, urged the rejection of the New York *Garrity* rule, but reasoned that this did not involve an issue of preemption. The court in its decision seems to have followed this reasoning and avoided the preemption issue.

The focus of the case came down to the terms of the contract. *Shearson* took the standard position of brokerage firms over recent years that the parties had agreed to be bound by New York law, which included the *Garrity* rule that prohibited punitive damages in arbitration. However, the court rejected that argument finding that there was nothing in the contract that constituted evidence of an intent to bar punitive damages.

Shearson's form client agreement included in the arbitration provision that "any controversy" arising out of the account shall be settled by arbitration in accordance with the rules of the NASD and the New York Stock Exchange. There was no explicit reference to claims for punitive damages.

The court determined that the best way to harmonize the broad arbitration agreement with the choice-of-law provision to include only New York's substantive rights and obligations and not the state's decisional law allocation power between courts and arbitrators.

The Supreme Court sought to interpret the agreement between the *Mastrobuonos* and *Shearson* in accordance with analytical approach which could embrace the entire document coherently, reconciling the arbitration and choice-of-law provisions.

As a matter of contract interpretation, construing ambiguous language against the party that drafted it, and giving due regard to the "federal policy favoring arbitration, and the ambiguities as to the scope of the arbitration clause itself [to be] resolved in favor of arbitration" (*Volt*, supra, at 476), the court found no expression of an intent to preclude an award of punitive damages.

According to many securities experts, the effect of Mastrobuono will be increased pressure upon brokerage firms to settle cases due to the risk of punitive damages. Securities arbitration became the rule for broker-customer dispute resolution after the U.S. Supreme Court decision in *Shearson v. McMahon*, 482 U.S. 220 (1987), supporting enforcement of predispute arbitration agreements.

There is virtually universal use of binding arbitration provisions in major brokerage firm customer agreements, and thousands of arbitration cases are filed each year. But only a relatively small percentage of cases had included awards of punitive damages in the wake of the *Garrity* and *Barbier* decisions.

It has been suggested that the low number of arbitration awards which included punitive damages in recent years reflected the intimidating factor of the now rejected New York cases on the authority of arbitrators, which brokerage firms frequently cited in their defenses as potential grounds for appeal.

However, in light of *Mastrobuono*, arbitrators will now be free to use all remedies available to form equitable awards, including rendering awards of punitive damages in appropriate cases, unencumbered by the brokerage firms' procedural efforts to bar such remedies.

The Legacy of 'Raytheon'

The Supreme Court decision in *Mastrobuono* is consistent with the prior judicial authority in Massachusetts. In *Raytheon Co. v. Automated Business Systems Inc.*, 882 F.2d 6 (1st Cir. 1989), the Appeals Court ruled that commercial arbitrators indeed have the authority to award punitive damages. The *Raytheon* case, decided by the 1st Circuit including then Judge Bryer, was perhaps a progenitor of *Mastrobuono*.

In *Raytheon*, the 1st Circuit held that a general arbitration clause (which provided that "all disputes" arising in connection with the agreement shall be settled by arbitration) and the broad policies of the FAA empower an arbitration panel to award punitive damages. The court found no clear mutual understanding or exclusion from the general language of the arbitration clause which would prohibit punitive damages.

The *Raytheon* case emphatically rejected the *Garrity* position that punitive are a form of sanction reserved for the courts alone. Expressing its disapproval of *Garrity*, the *Raytheon* court quoted a commission as "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."

The court noted that an agreement to resolve a dispute through an expedited procedure does not imply that the parties must give up a legitimate claim of damages.

Federal Policy and NASD Rules

In *Mastrobuono*, following *Raytheon*, the court cited the broad federal policies of the Federal Arbitration Act which declare a national policy favoring arbitration and which limit the power of the states to interfere with that policy.

Although *Raytheon* ruled based upon federal law, the *Mastrobuono* decision, through a narrow reading of the choice-of-law provision, did not directly address the question of preemption of state law by the FAA. But clearly there was an overriding concern with supporting the FASS; pro-arbitration policy, respecting substantive rights and remedies in arbitration, and safeguarding against any vestige of state judicial hostility towards arbitration.

The *Mastrobuono* decision also relied upon the arbitration rules of the National Association of Securities Dealers, which were incorporated in the standard *Shearson* customer agreement. The NASD Code of Arbitration Procedure states generally that arbitrators may award "damages and other relief," which clearly does not preclude punitive damages.

Also, the court noted the NASD Manual provided to arbitrators contains the following provision:

"B. Punitive Damages

The issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy.”

The court in *Mastrobuono* viewed the agreement of the parties to resolve disputes through arbitration in accordance with the NASD rules as an indication that punitive damages are indeed permissible.

In *Raytheon*, the court had found similar support in the American Arbitration Association rules authorizing arbitrators to award any form of just and equitable remedy. (There was no implication that the results would be contrary in a New York Stock Exchange arbitration.)

Raytheon also cited *Ehrlich v. A.G. Edwards and Sons, Inc.*, 675 F.Supp. 559, (D.S.D. 1987), which held arbitrators' power to award punitive damages is consistent with "the strong federal policy in favor of upholding an arbitrator's ability to fashion appropriate remedies." *Id.* at 565.

NASD Announcement Supports 'Mastrobuono'

The NASD has moved swiftly to foreclose the possibility that brokerage firms might attempt to frustrate the rule of *Mastrobuono*.

The Supreme Court decision in *Mastrobuono* seemed to leave open the question as to whether brokerage firms could explicitly preclude punitive damages through clear, unequivocal language in the customer agreement that would leave no doubt as to the intention to prohibit the arbitrators from rendering an award of punitive damages.

However, the NASD has announced that NASD Rules of Fair Practice §21(f)(4) prohibit the use in customer agreements of any language that "limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award" (emphasis added).

In the wake of *Mastrobuono*, the NASD has issued a notice that brokerage firms using arbitration provisions in customer agreements which are inconsistent with the above rule may be subject to disciplinary action, and that arbitration panels will view as inconsistent with NASD rules provisions in agreements that may be construed as limiting the ability of arbitrators to issue awards. NASD Notice to Members 95-16. This was specifically aimed at possible efforts by firms to circumvent the holding of *Mastrobuono* through restrictive customer agreements.

Conclusion

As indicated in an amicus brief filed with the Supreme Court in *Mastrobuono* on behalf of the Public Investors Bar, "Punitive damages are necessary to police adequately the securities industry ... which is involved in the sensitive fiduciary task of giving financial advice and investing other peoples' money on a commission basis."

The high court has sent a clear message to the securities industry that individual investors may not be deprived of their rights through preprinted boilerplate forms, the terms of which are not only generally non-negotiable, but typically not even discussed and rarely even read. The securities industry's immense power to set the terms of its agreements must be balanced with the protection of individual investor's rights.

The problem of rogue brokers, securities fraud and inadequate supervision has become more visible recently, especially in light of the Barings and Prudential scandals. Certain securities arbitration cases merit awards of punitive damages to provide a disincentive to fraud, to punish intentional, flagrant or reckless activity, to set an example and to prevent securities brokers from taking advantage of the public trust.

In *Mastrobuono*, the Supreme Court has made it clear that there is a place for punitive damages in securities arbitration and that securities arbitrators do have the authority to award punitive damages.

As a matter of practice, this new clarification of the law should assist the parties and counsel to more seriously consider the risk of punitive damages in evaluating the strengths and potential costs of their case, and to weigh this element of damages in settlement negotiations.

At the same time, counsel for investors should be prepared to argue for punitive damages as a sanctioned element of damages in securities arbitration cases, citing *Mastrobuono* to provide the arbitrators with a basis on which to render an award which includes punitive damages in the proper circumstances.

Hopefully the risk of punitive damages may further heighten sensitivity in the securities industry to compliance and supervision issues, thereby deterring fraudulent activity. Surely that is the desired goal.