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Punitive Damages in Securities Arbitration

by Holly S. Stein and Lynn Bolinske

As a result of three recent decisions by the U.S. Supreme Court,[1] there has been a dramatic increase in the number and complexity of securities disputes resolved through arbitration. Claims involving the Securities Act of 1933, the Securities Exchange Act of 1934 and the Racketeer Influenced Corrupt Organization Act ("RICO") are subject to arbitration before forums sponsored by the Self-Regulatory Organizations ("SROs")[2] and the American Arbitration Association ("AAA"). Many securities arbitration proceedings also include common law claims for relief such as fraud, negligent misrepresentation and breach of fiduciary duty on which punitive damages may be awarded by judges and juries. Arbitrators are awarding punitive damages with increasing frequency.

This article discusses the issue of whether arbitrators have the authority to award punitive damages. This issue is much debated and has created conflicts among the jurisdictions. Courts which have considered this issue have focused on the parties' agreement to arbitrate, which is usually part of the customer agreement signed by the parties, and the relationship between federal and state arbitration law. Some courts have held that, as a matter of public policy, arbitrators cannot award punitive damages.[3] However, the trend is to permit punitive damages in arbitration pursuant to the Federal Arbitration Act ("FAA").[4]

The Federal Arbitration Act

In 1925, Congress enacted the FAA.[5] The FAA, which applies to contracts involving interstate commerce or maritime affairs,[6] does not expressly prohibit punitive damages. Because virtually all securities transactions involve interstate commerce, the FAA applies to securities arbitration proceedings unless otherwise agreed by the parties.

The FAA created federal substantive law, applicable in both federal and state court proceedings, which preempts any conflicting state law.[7] Therefore, if the FAA applies, the court must determine whether state law also is applicable and to what extent the state law is preempted.

Choice of Law Provisions

In the past, arbitrators on SRO panels assumed that punitive damages were unavailable, even in the most egregious cases. This assumption arose from a number of New York state cases which held that arbitrators did not have the authority to award punitive damages. Because most customer agreements containing arbitration clauses also contained choice of law provisions specifically stating that New York law applied, arbitrators were advised (formally and informally) by the arbitration departments of the SROs that they could not award punitive damages.

The seminal New York case on the propriety of punitive damages in arbitration is *Garrity v. Lyle Stuart, Inc.*[8] In *Garrity*, the New York Appeals Court held that

> [s]ince enforcement of an award of punitive damages as a purely private remedy would violate public policy, an arbitrator's award which imposes punitive damages, even though agreed upon by the parties, should be vacated.[9]

Garrity involved a dispute between a publisher and an author over royalty payments on a book. The publishing contract contained a broad arbitration clause, but it did not expressly provide for the imposition of punitive damages. The court found that the parties never agreed to or considered punitive damages for a breach of the publishing contract.[10] Notably, the *Garrity* opinion did not include an analysis of the relationship between the FAA and New York law.

Reaffirmation of *Garrity* by Second Circuit

While many courts and commentators have criticized the *Garrity* ruling (as discussed below) it remains viable precedent in New York. *Garrity* recently was reaffirmed in *Fahnestock & Co., Inc. v. Waltman*, where the Second Circuit held that a choice of law provision designating New York law compelled vacating a punitive damages award under the *Garrity* rule, despite the fact that the contract was governed by the FAA.

This column is prepared by the CBA Alternative Dispute Resolution Committee. This month's column was written by Holly S. Stein, Denver, a partner of Holland & Hart and former Director of Arbitration for the American Stock Exchange, Inc., and Lynn Bolinske, a senior associate of Holland & Hart.

Fahnestock involved a claim of defamation arising out of a dispute between a New York securities firm and a former employee it had discharged. The employee was awarded $270,000 in damages, including $100,000 in punitive damages. The court ruled that unless an arbitration contract specifically allowed for punitive damages, New York law prohibiting such awards applied.

The Second Circuit premised its ruling in *Fahnestock* on the fact that the court was exercising diversity jurisdiction, rather than federal question jurisdiction. The court found that

> [t]he measure of damages in general is matter controlled by New York substantive law where federal jurisdiction in New York is predicated on the diversity of the parties.[12]

One Second Circuit judge filed a dissent on the punitive damages issue questioning the majority's reliance on the diversity jurisdiction/federal question jurisdiction distinction.[13] The dissent would have reversed the district court's affirmance of the punitive damages award. It also would have remanded the case for findings regarding the intent of the parties on the availability of punitive damages when they contracted.

Other Circuits Allowing Punitive Damages

The *Garrity* rule has been rejected by courts outside New York that have considered the issue. *In Bonar v. Dean Witter Reynolds, Inc.*,[14] the customer agreement also contained a choice of law provision selecting New York law. The Eleventh Circuit declined to apply *Garrity* and held that a choice of law provision in a contract governed by the [FAA] merely designates the substantive law that the arbitrators must apply in determining whether the conduct of the parties warrants an award of punitive damages; it does not deprive the arbitrators of their authority to award punitive damages.[15]

A First Circuit case, *Raytheon Co. v. Automated Systems, Inc.*,[16] involved a contract with a California choice of law provision and the AAA as choice of forum. In *Raytheon Co.*, the court adopted "a rule favoring the arbitrability of punitive damage claims."[17] The court found no compelling reason to prohibit a party from recovering punitive damages in an arbitration." It further noted that parties are entirely free to draft arbitration provisions that exclude punitive damages. In *Raytheon*, there was no such exclusion from the general language of the arbitration clause.[19]

"The Federal Arbitration Act created federal substantive law, applicable in both federal and state court proceedings, which preempts any conflicting state law."

CRS § 13-21-102(5)

In 1986, the Colorado legislature adopted CRS § 13-21-102(5), which prohibits the awarding of punitive damages in administrative or arbitration proceedings, even if the award or decision is enforced or approved in an action commenced in a court, unless otherwise provided by law. Since then, the effect of CRS § 13-21-102(5) has been unclear to Colorado arbitrators. While they were told by the SROs that the FAA allowed punitive damages, CRS § 13-21-102(5) appeared to be in direct conflict.

Recent Case Law Overriding CRS § 13-21-102(5)

Recently, the U.S. District Court for the District of Colorado issued an opinion in *Pyle v. Securities U.S.A., Inc.*,[20] which concluded that CRS § 13-21-102(5) did not bar the arbitrators from awarding punitive damages. In *Pyle*, the claimant filed a claim with the National Association of Securities Dealers ("NASD"), alleging (1) violations of § 12(2) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934 and § 11-51-125(2) and (3) of the Colorado Securities Act of 1981; (2) Colorado common fraud; and (3) misrepresentation in a suitability case. The arbitrators ruled in favor of the claimant. They awarded compensatory damages, punitive damages and attorney fees.

Based on CRS § 13-21-102(5), the respondents sought to vacate that portion of the arbitration award which granted punitive damages. It was undisputed that the FAA applied to the parties' dispute. There was no customer agreement at issue in *Pyle*. The parties agreed to resolve their dispute before the NASD pursuant to a standard form submission agreement, which incorporated the NASD Code of Arbitration Procedure ("NASD Code").

> The Pyle opinion held that absent an agreement by the parties that state arbitration law should govern, state arbitration law restricting an arbitrator's power to award punitive damages does not apply to an action under the FAA."

Because the parties did not expressly agree that their dispute was governed by Colorado arbitration law, CRS § 13-21-102(5) was not applicable and did not bar an award of punitive damages by the arbitration panel. The opinion distinguished the U.S. Supreme Court's recent opinion on a related issue in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*,[22] in which the arbitration agreement included d choice of law provision selecting California law. In *Volt*, the Supreme Court held that a choice of law clause requires parties' disputes to be governed by the state's law which they have chosen when the FAA is silent on the issue.

Pyle also relied on the NASD submission agreement executed by the parties, which incorporated the NASD Code. Pursuant to § 1 of the NASD Code, the parties agree to arbitrate "any dispute, claim or controversy arising out of or in connection with the business of any member of the Association." The opinion held that the language "any dispute, claim or controversy" was sufficiently broad to include a claim for punitive damages, thus rejecting the respondents' claim that punitive damages were outside the scope of the arbitration agreements.[23]

Choice of Forum Provisions Examined

In some cases, courts have found that a choice of forum provision determines the availability of punitive damages. As noted above, the **Pyle** court found that the parties agreement to arbitrate before the NASD and the incorporation of the NASD Code into the submission agreement indicated an intent to permit the arbitrators to award punitive damages, if appropriate. Similarly, in *Bonar*,[23] the Eleventh Circuit held that the choice of forum provision selecting the AAA — and thereby incorporating AAA Rule[25] — authorized the arbitrators to award punitive damages, despite a choice-of-law provision selecting New York law.

In contrast, the *Fahnestock*[26] court interpreted the New York Stock Exchange's ("NYSE") omission of the issue in its arbitration provisions as prohibiting punitive damages.[27] The Second Circuit found the NYSE Rules contained no provision similar to the AAA rules granting the power to award appropriate "remedy or relief." Therefore, the court concluded that the NYSE Rules do not permit punitive damage awards: "Clearly, if the NYSE wanted to empower arbitrators to award punitive damages, it could have done so."[28] Such

an analysis may prompt the NYSE to amend its arbitration rules to mirror the AAA's broad language.

Conclusion

The power of arbitrators to award punitive damages may become the next securities arbitration question to be decided by the U.S. Supreme Court. The stage is being set for direct conflict among the circuits. *Pyle* answered some questions for practitioners in Colorado, but left many other issues unresolved.

The practitioner is advised to review the jurisdiction's law which governs the parties' relationship, in order to determine whether an arbitrator is empowered to award punitive damages in the particular case. The trend, outside of New York, clearly favors the permissibility of punitive damages in securities arbitration pursuant to the FAA.

NOTES

1. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989) (holding that claims arising under the Securities Act of 1933 are arbitrable); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (holding that claims arising under the Securities Exchange Act of 1934 and RICO are arbitrable); and *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985) (holding that common law claims are arbitrable).

2. The ten SROs are as follows: (1) American Stock Exchange, Inc.; (2) Boston Stock Exchange, Inc.; (3) Chicago Board of Options Exchange, Inc.; (4) Cincinnati Stock Exchange, Inc.; (6) Municipal Securities Dealers, Inc.; (7) National Association of Securities Dealers, Inc.; (8) New York Stock Exchange, Inc.; (9) Pacific Stock Exchange, Inc.; and (10) Philadelphia Stock Exchange, Inc.

3. *Garrity v. Lyle Stuart, Inc.*, 353 N.#.2d 793 (N.Y.S. 1976); *Anderson v. Nichols*, 359 S.E.2d 117 (W.Va. 1987); *Shaw v. Kuhnel & Assoc., Inc.*, 698 P.2d 880 (N.M. 1985).

4. See, e.g., *Raytheon Co. v. Automated Business Systems*, 882 F.2d 6 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); and *Pyle v. Securities, U.S.A., Inc.*, 758 F.2d 638 (D.Colo. 1991).

5. 9 U.S.C. § 1-14(1991).

6. 9 U.S. C. § 2.

7. *Southland Corp. v. Keating*, 465 U.S. 1, 12 (1984); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983).

8. *Garrity, supra*, note 3.

9. *Id*. at 833.

10. *Id*. at 834.

11. 935 F.2d 512 (2nd Cir. 1991).

12. *Id*. at 518.

13. *Id*. at 519-522.

14. *Bonar, supra*, note 4.

15. *Id*. at 1387 (*citing, Willoughby Roofing & Supply Co., Inc. v. Kajima International, Inc.*, 598 F. Supp. 353 (N.D. Ala. 1984) (a choice of law provision does not deprive the arbitrators of their power to award punitive damages under a contract governed by the FAA).

16. *Raytheon, supra*, note 4.

17. *Id*. at 12.

18. *Id*.

19. *Id*.

20. *Pyle, supra*, note 4.

21. *Id*. at 639.

22. 489 U.S. 468 (1989).

23. *Pyle, supra*, note 4 at 640.

24. *Bonar, supra*, note 4.

25. American Arbitration Association Commercial Arbitration Rules § 42 provides that:

> [t]he arbitrator may grant any remedy or relief which he deems just and equitable and within the scope of the agreement of the parties.

26. *Fahnestock, supra*, note 11.

27. Article XI of the NYSE Constitution provides that

> [a]ny controversy between . . . a member, allied member, or member organization and any other party, arising out of the business of such member . . . shall at the instance of any such party, be submitted for arbitration . . .

2 NYSE Guide (CCH) ¶ a1501. NYSE Rule 600(a) provides for the arbitration of "any disputed, claim or controversy," 2 NYSE Guide (CCH) ¶ a2600, and NYSE Rule 347 provides for the arbitration of "any controversy . . . arising out of the employment or termination of employment . . ." 2 N.Y.S.E. Guide (CCH) ¶ a2347.

28. *Fahnestock, supra*, note 11 at 519.