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Punitive Damages

PUNITIVE DAMAGES

Introduction

PROF. COFFEE: We are now going to take up punitive damages, which this year, frankly, is the tenderloin issue. There are going to be dramatic developments in this field, and to give you a preview of what may happen we're going to have Paul Dubow of Dean Witter and Gus Katsoris who needs no introduction.

Paul is an active litigator with Dean Witter, has represented the Securities Industry Association for some time at the Securities Industry Conference on Arbitration, and has worked on its drafting committee.

Gus, of course, has been working on SICA since it was invented and has probably forgotten more about arbitration than I'll ever know. Both of them are in a good position to predict for us what the Supreme Court is going to do.

If we can, I want to force people to tell us what the courts are going to do because I'm never right and I want you people to be wrong also.

Panelists

MR. DUBOW: First of all, I guess the bottom line here is whether punitive damages should apply at all in arbitration. In my view, arbitration is a forum for adjudication, not a forum for punishment. Punitive damages are a form of punishment.

Now, let's look back at the history of punitive damages—how they began. They were designed by the state to punish wrongdoers. They were developed to punish defendants who were willing to act in an outrageous fashion because the risk of paying compensatory damages was far outweighed by the fruit of their outrageous conduct. So, the power to award punitive damages against these defendants was the only practical way of restraining their conduct. It had its pitfalls, but at that point there was no other way to do it.

In those days, when we first had punitive damages, there were no regulatory bodies of any consequence to regulate conduct in a particular industry. There were no statutes that had punitive restrictions to them, such as RICO[240] or the Sherman Antitrust Act.[241] And so, for that reason there developed the concept of punitive damages. Obviously, that concept has its flaws. For one thing, a victim could obtain a windfall while other victims, who for some reason or another were unable to sue or sue successfully, would not be compensated for that outrageous conduct.

240. Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 (1988).

241. Sherman Act, 15 U.S.C. §§ 1-7 (1988 & Supp. IV 1992).

Another problem with punitive damages is that it may be unfair to a defendant who is adequately punished in a first lawsuit, and then is required to pay punitive damages again and again in subsequent suits.

So, now we look at the securities industry. In the securities industry, there is an ability to punish a wrongdoer. It's put on the back burner a lot by people, but, the fact is, it's a very strong deterrent to members of the industry and a bigger deterrent than the payment of punitive damages.

I can speak for my own firm. Only about a month ago, we paid a $50,000 fine to the Exchange. The main reason was that we were late in filing about three percent of our U-5s.[242] We spent more on legal fees and time trying to negotiate that fine, and then we had to spend time answering to our own people and to others why we did this. This had a greater effect than a punitive damages award. Punitive damage awards tend to get in the papers and the next day they are forgotten. But, the disciplinary process in the industry is very strong and it is a very real one, more so today than it ever has been.

Furthermore, even in arbitration, the arbitrators have the power to make disciplinary referrals. They do so today in all of the fora. In fact, they can make a disciplinary referral even if the brokerage firm wins the case. For example, they may find that a plaintiff cannot recover on a claim of unauthorized trading because the plaintiff ratified the conduct of the broker. The broker nonetheless committed a violation of the securities laws or the Exchange rules. Therefore, in that case, it is quite possible that the arbitrators, while finding for the respondent on the ground of ratification, could still issue a disciplinary referral and, in fact, they have done so. I've seen it.

Even if arbitrators fail to make a referral for discipline in an arbitration, but award $5000 or more to that plaintiff, that begets a filing in the Central Records Depository ("CRD") system via a U-4[243] if the employee is still with the firm or a U-5 if that person is not with the firm. If the award is $15,000 or more, then what's called an RE-3[244] has to be filed with the New York Stock Exchange. And, I know that the New York Stock Exchange investigates every single RE-3 that is filed.

These avenues are available, and the risk of punishment is always out there. Ironically, the CRD system and the RE-3 system, to a small degree, are deterrents to the settlement of cases because an employee

242. Form U-5, Uniform Termination Notice for Securities Industry Registration.

243. Form U-4, Uniform Application for Securities Industry Registration or Transfer.

244. New York Stock Exchange, Inc., Division of Enforcement, Form RE-3. Whenever a securities or commodities-related civil litigation or arbitration is disposed of by judgement, award, or settlement for an amount exceeding $15,000, it is considered a reportable event under New York Stock Exchange Rule 351, and, therefore, a Form RE-3 must be filed with the New York Stock Exchange, reporting the defendant or respondent to the Exchange. NYSE Rules, *supra* note 14, Rule 351, ¶ 2351.

may not want to settle a case while the employer may want to settle because the settlement affects the employee's record when he or she has to file a U-4 or an RE-3. The point is, there is an adequate means of punishment out there in the securities industry. There is no need to have, on top of that, an additional punishment with all its draw-backs in the form of punitive damages.

Those who support the right of claimants to be awarded punitive damages in arbitration state that they should have the same right in arbitration that they have in court. If they can get punitive damages in court, they should be able to do so in arbitration. If you examine those arguments, however, you find that is not what they're saying. What they're saying is that they want more rights.

All you have to do is look at the briefs in the *Mastrobuono*[245] case. The plaintiff and the amici briefs argue that punitive damages should be available in all arbitration fora no matter what jurisdiction that arbitration is filed in. That means that a plaintiff could be awarded punitive damages in any of the nine states in which he or she could not obtain punitive damages in court; or, be awarded any amount of punitive damages in the seven states that cap punitive damages; or, keep the full amount of the punitive damages award in the two states that require a portion of the punitive damages award go to the state; or, be awarded punitive damages on any cause of action, including a violation of federal securities laws, without proving any standard to establish alleged outrageous conduct.

You may be surprised when I say that, but under the present system, a plaintiff can obtain punitive damages merely by alleging a 10b-5 violation in arbitration, even though he or she couldn't do so in court,[246] because arbitrators don't have to follow the law. If you are a respondent and the plaintiff only sued you for a 10b-5 violation and obtained a punitive damage award, there is no way you could get that award vacated.

You may have heard of manifest disregard of the law as a ground for vacation. However, the Federal Arbitration Act[247] and the Uniform Arbitration Act[248] have five or six specific requirements for va-

245. Mastrobuono v. Shearson Lehman Hutton, Inc., No. 94-18, 1995 U.S. LEXIS 1820, at *21 (U.S. March 6, 1995), *rev'g* 20 F.3d 713 (7th Cir. 1994). Petitioner's brief available in WESTLAW, 1994 WL 646148. Respondent's brief available in WESTLAW, 1994 WL 699700.

246. *See* Green v. Wolf Corp., 406 F.2d 291, 303 (2d Cir. 1968) (holding that punitive damages cannot be recovered in a suit under Rule 10b-5), *cert. denied*, 395 U.S. 977 (1969); deHaas v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970) (same). The plaintiff, however, may be able to recover punitive damages pursuant to a pendent cause of action under state law joined with the 10b-5 action. Richard W. Jennings, et al., Securities Regulation: Cases and Materials 1347 (7th ed. 1992) (citing Young v. Taylor, 466 F.2d 1329 (10th Cir. 1972) and Cyrak v. Lemon, 919 F.2d 320 (5th Cir. 1990)).

247. 9 U.S.C. §§ 1-15 (1988).

248. Unif. Arbitration Act, 7 U.L.A. §§ 1-25 (1985 & Supp. 1994).

cation of awards,[249] none of which include manifest disregard of the law. There have been some awards reversed on that ground, but they are very few and far between.[250]

There are certain fallacies raised with respect to the issue of punitive damages. One fallacy is that it is the only way by which a plaintiff in an arbitration matter can be made whole. Perhaps so, but that is really an argument for the English rule.[251] Another fallacy that we hear primarily from lawyers is that punitive damages are the best way by which the industry can be punished for its outrageous conduct. That sounds pretty good except that they rarely state that it is the best way by which they are compensated.

Let me give you this example. We had a meeting at the NASD about six or eight months ago that included the plaintiff's bar and the defense bar. By the way, I personally enjoyed that meeting. I felt it was very good to meet members of the plaintiff's bar, and there was a lot of mutual respect at that meeting. I hope we would have more of them to discuss mutual issues.

One of the things that I suggested was that if we are going to have punitive damages in arbitration, let the award go into a fund. Let's establish some kind of investors education fund and all punitive damage awards could go in that fund.

Initially that sounded pretty good. Then somebody said well, okay, but we still want to get our contingent fees. We lawyers who bring these suits still want to get our one-third or forty percent or whatever the case may be. I am one of the few defense lawyers who favors a contingent fee for plaintiffs' lawyers. I really think it is necessary, believe it or not. I'm probably a minority of one on that issue, but I do believe that.

But, why should there be a one-third recovery? The plaintiff's lawyer could be paid his or her hourly rate for obtaining the punitive damage award, but there should be subtracted from that amount the amount paid as a contingent fee for compensatory reward. If we did

249. The Federal Arbitration Act includes five grounds warranting vacation of an award: (1) the award was procured by corruption, fraud, or undue means; (2) there was evident partiality or corruption in the arbitrators; (3) 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 any other misbehavior by which the rights of any party have been prejudiced; (4) 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; or (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.

250. *See* Brad A. Galbraith, Note, *Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard" of the Law Standard*, 27 Ind. L. Rev. 241 (1993).

251. *See supra* note 144 and accompanying text.

that, I'm sure one hundred percent of the punitive damage award would go into this fund.

The point I'm trying to make is that a lot of lawyers who are in favor of punitive damages in arbitration are in favor of that because it's a good way of compensation for them, and not necessarily because it also well compensates the plaintiffs. If I were a plaintiff's lawyer, I would have the same viewpoint. I'm just saying that it is a fact of life.

There is an absence of due process with respect to the award of punitive damages in arbitration. It applies to all arbitration, not just securities arbitration. If you look at the Supreme Court cases on the subject and you compare it to arbitration, you see that.

In the *Haslip*[252] case, the Supreme Court affirmed an award of punitive damages that was issued by an Alabama court. In doing so, it said that the procedures in Alabama were satisfactory and did not violate due process. The court listed seven criteria that presumably assured that the process, or that the method, of awarding punitive damages in that state did not violate due process.[253] None of those seven criteria exists in arbitration. None of them.

Arbitrators have complete discretion to award punitive damages in securities arbitration. They can award them for, as I mentioned earlier, a violation of federal securities laws, even though the statute does not permit an award of punitive damages. I know of one case where a punitive damage award was issued because the arbitrator said that the defense attorney had failed to respond to a request for production of documents. That's not a ground to award punitive damages. Perhaps it is a ground to have the attorney referred to the state bar disciplinary committee.

In that particular case, all the attorney was doing was exercising the attorney's right to object to a request for production of documents. The plaintiff's lawyer in that case had not even asked the panel to rule on the objections made by the defense attorney. Nevertheless, a punitive damage award was issued in that case. Maybe it was an extreme situation, but it does illustrate what could happen in arbitration where punitive damage awards are allowed.

One may argue that arbitration is a private matter between contracting parties, and therefore, there is no state action. Of course, as we all know, in order to have a violation of due process, there must be some sort of state action.[254]

If you don't think there is state action in securities arbitration, then I suggest that you read the SEC brief in *Mastrobuono*.[255] The SEC

252. Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1 (1991).

253. *Id.* at 21-22.

254. *See* Ware, *supra* note 133, at 559-67 ("Numerous courts have held that the state action element of a due process claim is not present in arbitration.").

255. *See* SEC Brief, *supra* note 3, at 7, 10-12.

talks about section 21(f)4.[256] That is the section of the NASD rules that states that a customer's rights cannot be taken away by a contract in arbitration. And in order to uphold 21(f)4, the SEC says that 21(f)4 has the effect of federal law because it was approved by the SEC.[257] That aspect of that brief is correct. It is federal law.

Furthermore, if all the brokerage firms got rid of their arbitration agreements, they'd still have to arbitrate because they are members of SROs. SROs have arbitration requirements that can be taken advantage of by the customers of those brokerage firms. They can do nothing about that because they are compelled by, in essence, federal law to become members of the SROs if they want to do business as brokerage firms in this country.

There is state action with respect to at least securities arbitration. Perhaps, in other areas, not, but in securities arbitration it is clearly so. Therefore, the argument about due process is a valid one. There is clearly no due process.

I think it is also clear that punitive damages prolong arbitration. There have been arguments that the threat of punitive damages shortens the process because the fear of having a punitive damage award will make a respondent settle the case.

To a degree that's true, but only if both sides, the claimant and the respondent, agree that there is punitive liability. If the respondent thinks that it is liable and could face a punitive damage award, I suppose that respondent will try to settle the case as best it can. But, if the respondent does not believe it will be subjected to a punitive damages award, rightly or wrongly, and the claimant, rightly or wrongly, does believe that it has a punitive damages claim, the case will not settle. And, that's the majority of cases.

If anything, the concept, or the prospect, of punitive damages prolongs the arbitration process—hinders the arbitration process. It does not enhance it, in my view.

Finally, Robert Clemente has asked me to comment about what I think would happen post-*Mastrobuono*. I hate to disappoint, but I really can't say. Furthermore, I was talking to Mark Maddox at lunch, and neither one of us could figure out how the case is going to go. It could be reversed or affirmed in so many different ways that will affect what happens next in different ways.

For example, the Supreme Court could reverse simply by saying that 21(f)4 is part of the contract, that it supersedes the New York choice-of-law clause in the contract, and stop right there. That means

256. NASD Rules of Fair Practice § 21(f)4; *see also* NYSE Rules, *supra* note 14, Rule 636(d), ¶ 2636 (prohibiting limitations on the ability of a party to file a claim in arbitration); Uniform Code, *supra* note 14, § 31(d), at 24 (same).

257. *See* SEC Brief, *supra* note 3, at 7, 10-12.

that the issue of due process will not be raised. Where will we be then?

The Court also could find that the New York choice-of-law was superseded by 21(f)4, but that 21(f)4 cannot be the basis for a punitive damage award because such award would be a violation of due process.[258] That can happen too.

I don't know what's going to happen in the case, but I will say this: If the industry were to achieve a victory in *Mastrobuono* so that it could eliminate the ability of plaintiffs to obtain punitive damages in arbitration, I think the industry should give the public a method by which it could utilize the court system.

For example, perhaps there could be a system whereby certain types of accounts would have arbitration agreements and others wouldn't. Margin accounts, perhaps, could be the subject of arbitration agreements. They are not the majority of the types of accounts that are in brokerage firms. On the other hand, an IRA account would not be subject to an arbitration agreement.[259] Most of the partnership cases we saw at Prudential and other firms did not come out of margin accounts. Perhaps they wouldn't have been arbitrated. Who knows? But that's one possibility.

Another issue that we have to think about, post-*Mastrobuono*, is the proposed Common Sense Legal Reform Act.[260] Even if that does pass, does it affect arbitration? I read it in a very cursory fashion, so I really didn't study it that well. Although it says that it does apply to the federal securities acts, it does not apply to arbitration.

Even if the Act were passed, it's possible that all of the things that are in that Act would not apply to securities arbitration or perhaps only apply to those causes of action that allege violation of securities laws. So, I don't know where we're going to go from there, although I do see a trend in this country toward some sort of litigation reform. That may supersede whatever happens in *Mastrobuono*. Thank you.

PROF. KATSORIS: Of the seven topics covered in the Symposium, punitive damages is the only one that's being covered both days. I think that's because of the timeliness of the issue, namely *Mastrobuono*, and also because the subject is complex and the resultant consequences are very, very serious.

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258. The Court, in fact, found an amibiguity created by the New York choice-of-law provision in the customer agreement and so construed the ambiguous language "against the interest of the party that drafted it." Mastrobuono v. Shearson Lehman Hutton, Inc., No. 94-18, 1995 U.S. LEXIS 1820, at *18 (U.S. March 6, 1995) (citations omitted).

259. *See* 1992 GAO Report, *supra* note 54, at 28-29 (giving statistics on use of predispute arbitration agreements).

260. H.R. 10, *supra* note 167.

At the first session on punitive damages on November 21st,[261] I methodically went through the cases, and I don't want to repeat myself in this presentation. I want my presentation today to reflect what happened at the first session and build on it. I will also respond to Paul as I go along.

I basically staked out what I thought was the public's position, which is that if you can get punitive damages in court, you should be allowed to get the same relief in arbitration. I was then, and I continue to be, willing to talk about safeguards against run-away panels.

On the other hand, my very good friend John Peloso eloquently explained two weeks ago the evils of punitive damages, drew a line in the sand, and posted a sign that said no punitive damages should be allowed in arbitration, under any circumstances.

I look at it a little differently. When SICA adopted the Uniform Code,[262] its goal was to keep arbitration economical and speedy and achieve uniformity among the self-regulatory organizations ("SROs"). It was never intended to be used as a vehicle to eliminate remedies a customer already had in court through the use of restrictive clauses inserted into what is basically a mandatory pre-dispute arbitration agreement.

I say mandatory because, other than in cash accounts, a customer basically must sign one of these agreements to open an account.[263] Indeed, last week in the *Wall Street Journal*, there was a feature article that highlighted the inclusion of two such restrictive clauses in a recent arbitration agreement of a major brokerage house.[264]

The first of such restrictions provided: "The foregoing agreement to arbitrate does not entitle me to obtain arbitration of claims that would be barred by the relevant statutes of limitations if such claims were brought in a court of competent jurisdiction."[265]

I assume what the brokerage firm is attempting to do with that clause is to litigate the so-called six-year rule[266] in court instead of it being decided by the arbitrators.

More importantly, that agreement contained a second restrictive clause that provided, in part:

> This Agreement . . . shall be governed and construed in accordance with the laws of the State of New York, including, but not limited to, the law of New York regarding the permissible rates of interest that may be charged and the law of New York regarding damages recov-

261. *See supra* pp. 1571-94.
262. *See supra* note 14.
263. *See* 1992 GAO Report, *supra* note 54, at 28.
264. Sicinolfi, *supra* note 109, at C1.
265. *Id.*
266. For a discussion of the six-year rule, see *supra* pp. 1533-50.

> erable in arbitration, without giving effect to principles of conflicts of law.[267]

This so-called New York choice-of-law provision apparently is used irrespective of where the customer resides, and even if the transaction were consummated outside of New York, for example, on the Pacific Stock Exchange.

Interestingly, the clause specifically highlights New York interest rates and the law of New York regarding damages recoverable in arbitration. Nowhere are the terrible words "punitive damages" used, nor is the lay customer specifically advised of the *Garrity*[268] prohibition. When questioned by the author of the article, the spokesperson for the brokerage firm responded in part, "We're not trying to take overreaching advantage of clients, but this is *still a business.*"[269] He said, what the firm is trying to do is take whatever protection is necessary and "to try to be in the spirit or at least the *body* of the law."[270]

You can interpret that statement in a lot of ways. To me it means *let the customer beware.*

I don't think that's the kind of message that the industry wants to give to the public. If I were Knute Rockne and this were a football game, I would plaster that industry lawyer's statement on the locker of every public customer.

Nearly three years ago SICA passed a rule amending the Uniform Code to provide that arbitrators may grant any relief they deem just and equitable.[271] That rule was intended merely to codify the already inherent powers of arbitrators to grant whatever relief a claimant could get in court. I might add that the American Arbitration Association already had a similar rule as to arbitrators' authority.[272]

When the SICA rule went to the various SROs for respective board approvals, it was ambushed by what has been aptly described as the corporate equivalent of a drive-by shooting. The battle lines were drawn.

It made no sense to fight duplicative, simultaneous battles at the ten SROs, so the NASD, which has the most cases, undertook, with the tacit approval of the other SROs, to enter into a dialogue to see if this issue could be resolved consensually, taking into consideration the legitimate concerns of both sides.

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267. Siconolfi, *supra* note 109, at C1.

268. Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 794 (N.Y. 1976) (holding that arbitrators cannot award punitive damages).

269. Siconolfi, *supra* note 109, at C11 (emphasis added) (quoting a lawyer representing Smith Barney).

270. *Id.* (same).

271. Uniform Code, *supra* note 14, § 28(h), at 21.

272. *See, e.g.*, American Arbitration Association, *Securities Arbitration Rules* § 42(c), AAA164-20M-4/93, *available in* WESTLAW, 1993 WL 495385, at *12 ("The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties . . . .").

The NASD grappled with this issue for over two years, and this summer distributed to its membership Notice 94-54, which I distributed, and which in effect identified alternative solutions that were then being discussed.[273] For three long years we were all patient because we felt that some progress was being made. Regretfully, however, the inflexible position taken by the industry at the November 21st session of this Symposium, that punitive damages should not be allowed under any circumstances, brings us back to square one.

If that's true, then three years of dialogue have been wasted, and I personally think that the industry missed a golden window of opportunity to forge a rule we can all live with. Now, the Supreme Court will tell us what we *must* do. Personally, I feel that the Court will decide the issue in favor of the public. Like Paul, I'm not sure on what ground the Court will decide this case. It could decide on the basis of the Federal Arbitration Act, or an interpretation of *Volt*,[274] or that *Garrity*[275] is outdated, or on the doctrine of adhesion,[276] or any number of other grounds.

Keep in mind, *Garrity* was a four-to-three decision that was rendered one year before the creation of SICA, and eleven years before *McMahon*, when arbitration was still basically voluntary and its procedures still suspect by the courts, as evidenced by the *Wilko* decision.[277]

Indeed, when you analyze *Garrity*, it said that there are no punitive damages allowable in arbitration even though the parties have agreed otherwise.[278] It is ironic that the industry is saying that the public is *freely* agreeing to the *Garrity* ban on punitive damages, yet the *Garrity* majority specifically states that the parties *cannot* consent to punitive damages.

If *Garrity* will not allow the parties to agree on punitive damages, why should a state outside of New York let the parties *agree* that *Garrity* applies, since *Garrity* itself *does not permit* freedom of choice on this issue? Nor is *Garrity* immune from attack even within the borders of New York. Last year, the Arbitration Committee of the New York County Lawyer's Association recommended to the New York Legislature that *Garrity* be overturned.[279] Enough on *Garrity*.

There are at least two other issues before the Supreme Court in *Mastrobuono*. First, there are the SRO rules themselves. Section 31 of the SICA Code specifically prohibits restrictive clauses in

273. National Association of Securities Dealers, NASD Notice to Members 94-54 (July 1994).

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

275. Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976).

276. *See* John D. Calamari & Joseph M. Perillo, The Law of Contracts § 9-44 (3d ed. 1987).

277. Wilko v. Swan, 346 U.S. 427 (1953).

278. *Garrity*, 353 N.E.2d at 794 (citation omitted).

279. New York County Lawyers' Association, Committee on Arbitration and ADR, Punitive Damages: A Proposal For Relief 9 (July 12, 1993).

customers' agreements that limit the ability of the arbitrators to make any award.[280] I think that statement is self-explanatory.[281]

Secondly, the Supreme Court should give greater concern to the issue of adhesion. One of the judicially imposed limitations on the enforcement of adhesion contracts is that even if the provisions are within the reasonable expectations of the parties, they will be denied enforcement if, considered in context, they are found to be unduly oppressive, unconscionable, or against public policy.[282]

Keep in mind that before *McMahon*, the basic effect of enforcing arbitration agreements was that you had to resolve your dispute before a particular SRO instead of going to court. This is not necessarily unduly oppressive or unconscionable on its face.

But now, the consequences have escalated to where the result is not only that you must come into SRO arbitration, but then we'll start cherry-picking your rights or remedies away. The brokerage agreement I described earlier does just that, and if allowed to stand, will mark the beginning of the erosion of the public's rights and remedies.

What other similar restrictive clauses does the industry have in store for the public? Somehow those words of the industry attorney keep ringing in my ear: "We're not trying to take overreaching advantage of clients, but this is still a business."[283] That kind of philosophy will only rekindle the *Wilko* court's distrust of arbitration.[284] To repeat: I predict that the *Mastrobuono* decision will favor the public.

Could I be wrong? Of course I could be wrong. It's an occupational hazard that we all learn to live with. I've been wrong before. I've eaten crow before. Besides, being Mediterranean, if you put a little olive oil, garlic, and oregano on it, crow doesn't taste so bad.

Enough of the polemics. As I said at the last session, no matter how *Mastrobuono* turns out, each side must accommodate the other on this most sensitive issue. Otherwise, we begin going down the slippery slope where we will once again make arbitration strictly voluntary.

The time for stonewalling is over. The Maginot line[285] defense failed in World War II. It is similarly going to fail if applied in securities arbitration. I would like today to put aside the gauntlet and in-

280. Uniform Code, *supra* note 14, § 31(d), at 24; *see also* NYSE Rules, *supra* note 14, Rule 636(d), ¶ 2636.

281. The NASD recently warned its members not to use any agreement that limits the arbitrators' ability to make an award. *NASD Issues Warning About Clauses In Predispute Arbitration Agreements*, 27 Sec. Reg. & L. Rep. 473 (1995).

282. *See* Calamari & Perillo, *supra* note 276, §§ 9-41 to 9-46.

283. Siconolfi, *supra* note 109, at C11.

284. Wilko v. Swan, 346 U.S. 427 (1953).

285. The Maginot Line was a mighty system of fixed fortifications along the eastern frontier of France. *See* The Columbia Encyclopedia 1658 (5th ed. 1993). "Like fortified lines since the Great Wall of China, the chief effect it had was to create a false sense of security; it could not eliminate the necessity for mobile warfare, and that particular lesson was thoroughly learned after the French collapse of 1940." *Id.*

stead offer an olive branch. No matter how *Mastrobuono* turns out, it will not, in the long run, solve the issue with finality.

In this connection, I would like to get back to NASD Notice 94-54 and use it as a platform from which to launch a dialogue. It discussed seven alternative proposals as possibilities, and that's what they really are, possibilities. I would like to offer my thoughts on the seven possibilities listed, then I'd like to hear from the industry on whether there is room for any dialogue, because no matter how *Mastrobuono* turns out, we're going to be back at the table. The Supreme Court is not going to solve all of the problems.

I'll just briefly go through the various suggestions.

First: *Rationale for the Award of Punitive Damages.* We need a record. I've always felt that we should have a record of all arbitration proceedings. To the extent that punitive damages are involved, I think, even more so, we need a good record. To the extent that punitive damages may some day become appealable, a good record becomes absolutely mandatory.

As far as a standard or a written opinion as to punitive damages, I think that's negotiable, and I would like to defer, as Paul said, to see what happens with tort reform and a standard generally.

Second: *Appeals.* The suggestion here is that the appeal process be within the NASD itself—an internal appeal. I think appeals are coming if we're going to keep punitive damages in arbitration, but I oppose an internal appeal, because if you are now having image problems on the selection of arbitrators at the trial level, you're going to multiply them ten-fold by having to select somebody to sit in an elite appellate capacity within an SRO forum. For example, will we set up criteria for challenging such appellate arbitrators, be it peremptory or for cause?

So, I don't think we should set up an appeal structure within the SRO. I think that the punitive portion of an award should be appealable to the courts.[286]

Third: *Arbitrator Training.*[287] I think we all agree that's an area where we've got to get together and improve it, particularly regarding punitive damages.

Fourth: *Standard for Award of Punitive Damages.* Again, that's negotiable, and I think I would have to defer to overall tort reform.

Fifth: *Bifurcation.* The NASD Notice suggests bifurcating the punitive damages portion of the proceedings. I oppose such separation on the ground that you would greatly delay the proceeding and significantly add to its cost. So, I oppose bifurcation. If you are hearing the case, you hear the whole case once, at one time.

286. In order to set up an appeal structure to the courts, an amendment to the Federal Arbitration Act would likely be necessary.

287. For a discussion of arbitrator training, see *infra* pp. 1679-94.

Sixth: *Caps on Awards for Punitive Damages.* I think that's negotiable. I think, however, we have to defer such discussion pending tort reform generally, and then pick it up from there.

It bothers me when someone spills some coffee on herself and gets a 2.7 million dollar punitive damage award because the coffee is too hot.[288] I can truly understand the need for some dialogue in this regard.

Seventh: *Sharing Punitive Damage Awards with Regulators.* Interesting concept. Two weeks ago I think we discussed it and a suggestion was made that maybe some portion of the punitive damage award should go to the SROs to help defray the cost of the arbitration process. I think you would have a very serious conflict-of-interest problem if the SRO is the administrator of the forum where punitive damages are awarded, and the monies come back to it. Again, this sharing concept may be negotiable, but only as part of overall tort reform. I would defer to see what they are going to do to overall tort reform before we can discuss this.

Finally, I have one additional suggestion, and that's something that's been kicked around, namely: *making arbitration voluntary* where there are punitive damages sought. In other words, if you want punitive damages, you'd be allowed to opt out and go to court. You can keep the present system as it is, but if you allege punitive damages, then you would be allowed the option of going to court.

The Prudential global settlement with the SEC[289] has opted away two important rights: the defense cannot assert statute of limitations, and the plaintiff cannot claim punitive damages, but participating in that procedure is optional, not mandatory. I don't see how you can make arbitration mandatory and exclude punitive damages.

Again, I offer an olive branch, but I am prepared to defend my turf. In any event, I really would like to see this dialogue move forward. I think we've wasted three years. We're all now looking at *Mastrobuono* like it is going to solve all the problems, and I don't think it will.

Discussion

MR. DUBOW: I disagree with you that the dialogue was wasted. The dialogue could have lasted three years, but regardless, I do believe that those meetings that we had with both sides of the bar pres-

288. *Big Jury Award For Coffee Burn*, N.Y. Times, Aug. 19, 1994, at D5 (awarding 2.7 million dollars in punitive damages to an 81-year-old woman who suffered third-degree burns after coffee spilled on her lap); *McDonalds Cup of Scalding Coffee: $2.9 Million Award*, Chi. Trib., Aug. 18, 1994, at C1. The trial judge subsequently reduced the punitive award to $480,000. *See Judge Reduces Award in Coffee Scalding Case*, Chi. Trib., Sept. 14, 1994, at C2.

289. Securities and Exchange Commission v. Prudential Sec. Inc., C.A. No. 93-2164 (D.D.C. Oct. 21, 1994) (Fourth Quarterly Report of Claims Administrator).

ent were good meetings, and, as I mentioned earlier, I hope they continue.

There were no polemics at those meetings. They were very professional. There was disagreement obviously, but oddly enough, certain other ideas came out of those meetings, not involving punitive damages, where there was some mutual agreement. So, I believe that they were useful, and I also agree with you that dialogue should continue.

On the issue of the Smith Barney contract, I am mildly amused by the reaction to that.[290] As you pointed out, there were three basic elements to that agreement that appear to be "restrictive." The first one is the statute of limitations. It said that the statute of limitations that applies shall be the one that the person could obtain in a court or that was available in a court of competent jurisdiction. Therefore, what Smith Barney was saying, as far as I can determine, is that the same statute of limitations that is a defense in court would be a defense in arbitration. How is this a restriction? If you take the argument that it is a restriction to a logical conclusion, what you are saying is that you want the claimants to have greater rights, i.e., no statute of limitations in arbitration, even though they are available in court.

The second "restriction" pertains to interest, and I'm not quite sure where that comes out. This is one of the ironies of the whole debate. The reason why the law of New York was put into the contracts is that, way back before all of us were born, the State of New York had a much more liberal rate of interest for margin accounts than other states. This is before the issue of a national rule on interest.

So, the brokerage firms wanted New York law to apply because they were paying a certain rate to get the money. They added a point or two to that money to get their own interest. And that was higher than the usury limitations in every state except New York. So, that's why that was there. I suspect that's the same reason why it is there now, though I'm not sure about that.

The third element of the contract is the punitive damages element. I will agree that if that section were applied to a client, let's say from Illinois where *Mastrobuono* comes from, and we agree that punitive damages was a right, then that would be a restriction. But ironically that contract is a better contract than the contract at issue in *Mastrobuono*. The contract at issue in *Mastrobuono* simply said the law of New York applies, while the Smith Barney contract points you in the direction of damages. So, I don't understand the hullabaloo about that contract.

As far as the interest in the phrase, "just and equitable," that goes back to the days before punitive damages in arbitration were common. When arbitration first began, as I think Judith pointed out when we first began, the objective was to have an expert come in who could

290. *See supra* note 264 and accompanying text.

adjudicate the case and render a just and equitable decision. There were no defenses based on the statute of limitations, ratification, or other issues. It was just a matter of the facts, and the arbitrator would decide.

Punitive damages has complicated that. The *Garrity* case, which has been charged to be a case that's hostile to arbitration, isn't hostile to arbitration. The court decided, in New York, that arbitrators should not have the power to award punitive damages, because the usefulness of arbitration would be destroyed if punitive damages were allowed to be decided by the arbitrators.

The court in New York was trying to enhance arbitration by letting it remain cheaper and more efficient than court action. I think it is a fact that punitive damages do not make arbitration cheaper and more efficient to try.

Now, with respect to the issue of appeal, that would solve the due process problem. But then again, as somebody pointed out earlier today, it takes away from the efficiency of arbitration.

Secondly, Gus, I don't know how we could have a contract, and perhaps you've thought of a way, I've been unable to do so, which provides for an appeal to the courts, because the statutes don't allow that. You could provide for a trial de novo, I believe. You could have a contract that provided for a trial de novo in court if a punitive damage award was rendered, but you can't provide, as far as I can figure out, for an appeal. You have to amend the statutes to do that, and that may be a major process.

And so, I don't know, maybe it is desirable. I am not saying it is or is not, but I don't think it is, at this point, viable. Therefore, I don't know what we can do about it.

The point is, and this is my final point, there would not be an argument on punitive damages really, ironically, if the same rules that applied in court applied in arbitration, but that's not what's asked for here.

PROF. COFFEE: Before I open this to comments, and this has been an interesting exchange of views, I'm interested to see if we can push this forward prospectively because there are aspects to both of your comments that suggest there might be some middle ground. And some of this may also touch upon areas like arbitrator training, which we'll get to this afternoon.

Your initial theme really worked off of *Haslip*, the Supreme Court decision, and you said that there is a problem with due process. It is probably a lesser problem to the extent that I can be very worried about punitive damages in the hands of a jury, but I may be a little bit less worried about punitive damages in the hands of a trained panel of arbitrators, particularly after Ted Levine gets through training them and making them very sensitive. Still, there is some problem there.

What I hear from Gus is that from his perspective, it's possible to try to domesticate punitive damages with such things as standards that might be built into the Code of Arbitration and some type of internal appeal mechanism.

Now, you mentioned appeal to a court. There are some problems with the parties privately, by contract, conferring jurisdiction on a court. There could be internal mechanisms.

What if we had a code that had most of the *Haslip* factors,[291] and they were in the hands of arbitrators who probably are as smart and as good as the average state court judge as in the *Haslip* case, and we had new training? Is that the kind of domestication of punitive damages you think the industry can live with?

MR. DUBOW: It is a step in the right direction. I think one problem is the quality of the arbitrators. For example, arbitrations traditionally have had at least one arbitrator, if not all of the arbitrators, who is familiar with the field that is the subject of the arbitration case. That was the way it was in securities arbitration when we first began, because initially, I believe, there were two members of the panel that were from the industry.

Now it is one member of the panel that's from the industry, but that's still fine if that one member of the panel is really from the industry. However, I rarely have a case in which the industry panelist is an active member of the industry. More often than not the industry panelist is a retired person. For example, the reason I have to leave early today is, I have an arbitration tomorrow, and the industry panelist is a person who retired in 1975 from the industry.[292] I know who this person is, and this person's been out of the industry for years. I question whether this person has the industry expertise on what's going on today.

Often times the industry panelist is a person who has a license, maybe a mutual fund salesman working door to door. That's the industry panelist. So, as long as there are such major limitations on the industry panelists, I still would have some doubts whether that would work. I'm not saying it wouldn't, and I think it is an avenue to be explored, but I think we have to address that.

MR. LEVINE: The debate, if you will, which repeats a lot of the debate that's been going on for a number of years, I think keys up one or two critical questions that we all assume in order to get to the result we want.

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291. Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 21-22 (1991) (O'Connor, J., concurring in part and dissenting in part).

292. NYSE Rules, *supra* note 14, Rule 607(a)(2), ¶ 2607 ("An arbitrator will be deemed as being from the securities industry if he or she: . . . (iii) is retired from or spent a substantial part of his or her business career [as a member, broker/dealer, government securities broker, government securities dealer, municipal securities dealer or registered investment advisor].").

And I think the question is, with the jurisprudence of this country—not only the *New York Times* article today, but the real experience of getting to the courts—what are the clients of the firms better off doing? Are they better off in getting their issues addressed by the firms in an alternative dispute resolution process or not?

I am fundamentally of the view that they are. Even with all the infirmities of the process, by and large, in today's society and going forward, the courts are not the avenue for redress; alternative dispute resolution is.

The debate over whether you can rework the arbitration process to deal with the issue of punitive damages, I think has been reversed as to what it should be. Your question, John, fairly posed the right issues. You talk about *Haslip*, but I read *Honda*[293] as saying that until you have a process that provides due process and protects all parties, how can you push and demand punitive damages, as opposed to saying can we create the process to do it?

What I am concerned about is if we took a panel of arbitrators from this room, which has a lot of very skilled and knowledgeable people, lawyers and otherwise, and asked them what are punitive damages—what has the Supreme Court of the United States said as to when they should be awarded, the standard for awarding them, where they should go, and how they should be administered—I bet most of this room would fail, and we in the industry would fail that test. John Coffee may pass my test, but the rest of us would fail it. A lot of juries fail it. On appeal these awards are knocked down because they are misperceived and misunderstood.

My concern about adding to the compromise, which is what you both suggested, and what I think Paul is alluding to, is that one needs to understand not only these items in here, but really where you want to come out in this process. Do you want to have a process that does resolve disputes quickly, efficiently, and, I think, for the betterment of both the firms and its clients; or, do you want to recreate a litigation context in which you are going to bog down, and let's say that constructively, in a process where the results will not be achieved for weeks, months, or years, which I believe is going to be necessary in order to put punitive damages comfortably into the arbitration process. Whether it is direction to the arbitrators, skill of arbitrators, the standard you look for, or how you make the record, it is simply not recording the proceedings, I would suggest.

What is the standard that will be applied to arbitration? How are you going to test? Are there rules of evidence when you are talking about punitive damages, could they be imposed? Who is going to be the adjudicator of that? How are you going to police the bar?

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

There are no remedies really for policing the people advocating. There's a whole series of issues when you go from alternative dispute resolution, which is resolving a dispute, to imposing a penalty. There is no industry in this country, I think in the world, that has more regulations than the securities industry. There isn't any. SEC, states, SROs, you name it. There is none who has so many people looking.

But the question is, if you are going to impose punitive damages, how are you going to do it in a manner where you fairly protect both parties, because I don't believe that only the firms or the individual defendants or respondents get hurt by punitive damages. I really believe clients will get hurt. They'll get hurt because of delay. They'll get hurt because of costs. They'll get hurt because there's going to be, I believe, reversals going the other way because of the extraordinary remedy it is.

We may end up and probably we have to end up—because philosophically neither the SEC nor the SROs can stand up and say there are adequate protections for those egregious cases that exist apart from punitive damages—concluding that you need to provide the protections to get there, to firms, in order for this dialogue to go forward, and I haven't seen that.

And for Gus, or anyone, to say it is negotiable on caps, this is not a negotiation. This is not a negotiation between the public and the industry over caps. This is fundamentally the ability of this industry to survive without protection, and that can't happen.

And I think it is so dramatic that I would urge everyone in the room to focus on these issues, yes, but to understand the context in which it is coming out.

In my view, the goal of this group would be not to have punitive damages in arbitration. What I mean by that, in conclusion, is firms by and large have to resolve clients' disputes, not in an arbitration with punitive damages, because if you end up in that circumstance, we all lose.

The focus has to be on a method of resolving those disputes without that process in order for us to both keep our clients comfortable and satisfy the firm and also provide a mechanism to move on, from a cost perspective. And I urge us all to try to move towards that goal.

PROF. COFFEE: Okay. If I hear you correctly, you're skeptical that we can marry arbitration and punitive damages because it would produce delay, and the cost would be borne largely by the client. I'm summarizing you that way because I want to go back to Gus, who hasn't really had a full opportunity to reply to Paul's second round, and see what your response is.

PROF. KATSORIS: I will try to be brief because I think there are a lot of other people in this room from whom I'd like to hear.

Paul—briefly on the issue of appeal—yes, if it is going to be appealed to the courts, I think you have to amend the Federal Arbitration Act. If you can't do that politically, then an internal appeal within the SRO could be possible, as Jack mentioned through an SRO rule change; but, as I stated before, I don't think an internal appeal is the way to go.

Ted, on the issue of *Honda*, I wrote my article, *Tower of Babel*,[294] three years ago—long before *Honda*, and I thought even then that in all fairness, appealability should be allowed as part of an overall punitive damages tradeoff. You should not have the prospect of punitive damages and no appealability whatsoever. I speak for myself, and that's my opinion. I don't speak for everybody in the public. Just like you or Paul don't speak for everybody in the industry.

It is my understanding that the industry is putting a lot of reliance on *Honda*. Yet, the *McMahon* case unanimously allowed RICO claims in arbitration despite the same limitations on appealability,[295] and there are treble damages in RICO,[296] which to me are *punitive* in nature.

On the issue of negotiation on some of these issues, it must be made in good faith. I think a lot could be done through negotiation, but somebody's got to move. *Somebody's* got to be a leader. No one wants to go first. I see a lot of hesitancy on the part of the industry. No one in the industry wants to be first. Bottom line, however, I think you've got to keep punitive damages, one way or the other.

Now, I've been a public investor for over thirty years. I've never sued my broker. I've been an arbitrator in a couple of hundred cases. I've never granted punitive damages. Not because I sit in New York. If I see the right case, I'm going to do it, regardless of *Fahnestock*,[297] until *Mastrobuono* tells me otherwise.[298] I am going to do it if I see the terrible act that I think would warrant it.

MR. LEVINE: Could I just interrupt you. What standard do you think is applicable in awarding punitive damages? In other words, what is the legal or just policy statement that is articulated as to when you make that decision?

PROF. KATSORIS: I haven't had to focus on it yet, because I haven't granted it. I haven't seen the appropriate facts. Like a statement that's been made regarding pornography: "I'll know it when I see it." I haven't seen it yet in the approximately two hundred cases

294. Katsoris, *supra* note 104.

295. Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 238-39 (1987).

296. *Id.* at 239-40.

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

298. *See generally* Scot J. Paltrow, *Panel Awards Punitive Damages Against Broker*, L.A. Times, Feb. 23, 1995, at D1 (discussing a $70,000 punitive damage award issued on February 15, 1995 by an arbitration panel sitting in New York).

that I have sat on. I have great deference for the Second Circuit, but it would not stop me if I saw the right case in New York.

I might add that in the *Fahnestock* case, one of the arbitrators was Mort Goodman, whose background had basically been in representing the industry. Mort, who recently passed away, was an attorney and was one of the original public members of SICA. Mort, to his credit, awarded punitive damages in *Fahnestock*.

But if we can't negotiate a settlement on the issue of punitive damages, then I think we have to make the arbitration process optional in such cases.

MR. COLBY: I should note that as a matter of policy, the views I express are my own and should not be attributed to the Commission or my colleagues at the SEC.

I would like to mention what Ted said, if I understood right, that punitive damages could ultimately be destructive to the industry, operating in a manner that didn't have appeal rights and safeguards.

I think the premise in the *Mastrobuono* brief was that if you have arbitration without all of the remedies that would be available in court litigation, including punitive damages, that it is destructive of arbitration. Arbitration becomes a second-class process if you take away remedies that are available in litigation. If certain remedies are not available only in arbitration, it will be damaging to the arbitration process itself.

Keep in mind that arbitration is not something that is mandatory for the customers or the industry. It is written into a contract in order to engage in business with the industry.

One possible alternative would be, if punitive damages are untenable under current conditions in arbitration, that you develop a different pattern where customers can go to court in cases where they seek punitive damages—probably not an attractive possibility, but it certainly is one.

And the Commission touched on the appealability issue in its *Mastrobuono* brief in footnote fourteen.[299] The brief suggested that if an award was grossly excessive it might also exceed an arbitrator's powers and might be vacated under the Federal Arbitration Act on that ground.

On the *Honda* issue, to some extent it is a choice. If you choose to engage in arbitration where you can't appeal, then you have essentially chosen to not appeal.[300] Thus, I think the brief disposes of that part of the *Honda* due process argument.

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299. SEC Brief, *supra* note 3, at 20 n.14.

300. *See* Ware, *supra* note 133, at 567-68 (citing D.H. Overmyer Co. v. Frick Co., 405 U.S. 174 (1972), for the proposition that parties who consent by contract to arbitration expressly waive their due process rights).

PROF. COFFEE: Bob, let me just push you on one thing you said. You were speaking of it being destructive of the process if there wasn't some threat of punitive damages. Now, do you really need punitive damages to protect the process, or do you need something lesser, like a scaled-down rule?

MR. COLBY: I didn't say that you needed the threat of punitive damages. I was not trying to address the private attorney general issue, although the Commission historically has been in favor of private attorneys general and their implied rights of action, and the Commission is in the process of developing positions on tort reform. I also was not addressing the relative merits of punitive damages. State legislatures and courts have made determinations about whether there should be such damages. More than forty states have determined that there should be. What I was trying to say is, it is important to the credibility and the acceptance of arbitration that you not have limitations.

PROF. COFFEE: That it mirror the civil law process?

MR. COLBY: Yes, that's right.

MR. DUBOW: I just want to address one issue to Robert, which illustrates my central theme here. When you say that a person can obtain punitive damages in court, but cannot obtain them in arbitration, that makes arbitration a second class method of adjudication.

In the State of Massachusetts, one cannot obtain punitive damages in court, yet in the *Raytheon*[301] case, the plaintiff obtained punitive damages in arbitration. Therefore, is it the Commission's view that a client who brings an arbitration in Massachusetts should not obtain punitive damages because that person couldn't obtain them in court, and alternatively, does that mean that if the answer is no and that the person should be able to obtain punitive damages in arbitration in Massachusetts, does that make the court system second class?

MR. COLBY: My view is that this is governed by state law where there isn't a discrimination against arbitration. So, if the state law does not allow punitive damages in court, they should not be allowed in arbitration. If a state puts a cap on how much is allowed in punitive damages, that should also apply to arbitration.

MR. DUBOW: Therefore, you would also say that if the state sets forth a standard, you'd apply that. For example, in some states, wanton and malicious conduct is a standard. In some states, you can't introduce evidence of wealth. In other states you can. You would also follow those rules as well?

MR. COLBY: Yes.

MR. CELLA: Listening to the debate, and I've listened to this debate for some years as a member of SICA, I note that the industry lived well when punitive damages were a fact of life in judicial pro-

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

ceedings. They survived. They had no problem. Now that the public customer is basically compelled to go to arbitration, if you say arbitration should not include the possibility of a punitive damage award, what you're doing is immunizing the industry from the prophylactic benefit, not only of an award of punitive damages for a claimant who deserves them based upon a standard that's met, but the public investor is damaged because the availability of a punishment for gross misconduct is no longer there.

So, are we really saying punitive damages should not be available in arbitration, or is the real argument that punitive damages should not be awarded by arbitration panels because they lack the experience, training, and understanding? That's two different things. And I think the argument really is the latter and not the former.

PROF. COFFEE: Let me see if I can follow up on that point, because it is a prospective, forward-looking point as to something that could be done to modify or correct the system so we can marry the two.

And here I'm going to fall back and rely on the inherent power of the professor to call on people. This is one of those rights that federal judges also have. I wonder if we can get Debbie Masucci to tell us a little bit more about the NASD Notice, which I believe is something that you're closely related to. It's come out. You've begun to get some comment, I expect. What's been the reaction? Is this something that's flying, or is this something that's just getting artillery fire?

MS. MASUCCI: I think it is something that, as you have said, is getting a lot of artillery fire. The NASD, through its National Arbitration Committee, has been reviewing the whole issue of punitive damages for at least three years.

One area where we thought we had obtained consensus and moved it forward was the development of an "Offer of Award" proposal,[302] which is very similar to the proposals that have been in legislative reforms—the loser pays concept. Paul Dubow, as well as Boyd Page, who is the past president of the Public Investors' Arbitration Bar Association, were involved in the development of the rule.

The rule received extreme criticism for its perceived punitive impact, especially on the small investor. What the critics didn't look at or focus on was that the rule, as developed by the NASD, only applied to claims over $250,000 and that it was recommended on a pilot basis.

The rule was crafted for the larger award or larger cases where generally, we are advised, the parties have done their research and know their case prior to filing. The hostility that arose from that rule snowballed and the debate then grew quite loud.

302. Self-Regulatory Organizations, Exchange Act Release No. 33,081, File No. SR-NASD-93-36, 58 Fed. Reg. 57881 (Oct. 20, 1993) (proposed rule change to section 41 of the NASD Code of Arbitration Procedure).

Simultaneously with the National Arbitration Committee viewing all of the alternatives, our Legal Advisory Board set up a separate subcommittee to study the issue and develop a report that is compiled into the Notice to Members. The concept or precept that they started with was that this is a very regulated industry, but these were the alternatives that everybody has been talking about to address the concerns regarding punitive damages.

Those concerns really were drawn from the fact, not that arbitrators have not granted punitive damage awards properly in the past, but that there could be a large punitive damage award from a run-away panel that might put a firm out of business. So, it is speculation and fear.

Secondly, regarding the issue of the cost of arbitration. Because of the threat of punitive damages, each arbitration case is being litigated more fiercely and costing the parties even more money. Even the smaller cases.

The report that's contained in the materials was not voted on by the Legal Advisory Board or the NASD's Board of Governors. It was put out there for comment. We received some comments. Not a lot. And the vast majority of them basically suggested that any decision in this area be put off until either the U.S. Supreme Court decided the *Mastrobuono* case or our Arbitration Policy Task Force[303] had reviewed the issue.

So, our posture as a forum right now is to sit back and see what the environment will bring us, and we don't know what that is.

PROF. COFFEE: Okay. I hope someone at this panel will comment later on whether the prospect of a run-away panel is like the Lochness Monster, the Unicorn, or whether it is not a mythical beast but something they've actually seen recently.

MR. EPPENSTEIN: I would like to put forward a different view getting at what you have just said. Initially, there was this fear of run-away juries and that punitive damages were going to be awarded indiscriminately and were really going to hit the industry hard.

As I recall in New York, the largest award the Second Circuit affirmed was a $1.5 million hit in *Aldrich v. Thomson McKinnon.*[304] They scaled it down from 3 million to 1.5 million. And someone asked about what standard was used. I remember Judge Duffy wrote in one of his opinions in that case that he had seen witnesses lie before, but he never saw anyone's glasses fog up.

Now, I don't see run-away arbitration panels. You certainly won't see repeaters if they are on a panel that comes in with a big award,

303. The Arbitration Task Force is also known as the Ruder Committee. *See* Margaret A. Jacobs, *NASD Panel To Study Reforms in Arbitration Process*, Wall St. J., Aug. 18, 1994, at C1.

304. Aldrich v. Thomson McKinnon Sec., Inc., 756 F.2d 243 (2d Cir. 1985).

because they'll be stricken peremptorily by the industry from every other panel that they are chosen to sit on.

Rick Ryder addressed the Symposium the first day[305] and came out with some figures where he said that the Securities Arbitration Commentator had done a comparison ratio of punitive damages against compensatory damages when they were awarded in the securities arbitration area, and he found that they were 1.1 to 1 in terms of the ratio.[306] He also said that punitive damages were not really awarded in that many cases. He said there were a total of about two hundred punitive awards in the history of securities arbitration since he's been keeping track, and that is much less than ten percent of all cases.[307]

So, I don't really know what the big dispute is about here on punitive damages. I think it is a way to help weed out the rogue brokers that we see from the claimants' end and the way to help weed out the rogue offices that we see in this area.

Domke on Arbitration said that arbitrators seek to do equity.[308] *McMahon* said that arbitrators could do whatever courts could do. From this debate, I think we are getting back into the realm of let's go to court on all of these issues, and that's what I've been hearing.

And, if I could just address what Mr. Dubow said a little earlier about the contract that was discussed in the Wall Street Journal recently.[309] My memory is that in that contract the brokerage firm has the right to go to court to stop the claimant from bringing a claim on a statute of limitations ground or on a six-year eligibility ground.

The contract also provides that for the statute of limitations, the law of the state of the claimant's residence will apply, not New York law. The brokerage firm wanted to apply New York law to punitive damages, but not to the statute of limitations.

Why? Because we have a six-year statute of limitations for breach of fiduciary duty, which is where you usually get your big award, even your big compensatory award. So, the firm wanted to go in and try to cut that out if it was going to find a claimant in a state, outside New York, that has a statute of limitations shorter than six years.

I just find in the pre-dispute arbitration clause area, where firms are now attempting to place limitations on customers and also in the punitive damage area, that we're heading back into the courtroom, and I don't think it is worth it. I think the industry ought to think about the perceptions that are being placed on it.

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305. *See supra* notes 160-64 and accompanying text.

306. *See Punitive Award Survey*, Sec. Arb. Commentator, May 1993, at 4; *see also Punitive Damages in Arbitration: Update Survey of Securities Arbitration Awards*, Sec. Arb. Commentator, Jan. 1995, at 15 (reporting that in the updated survey the ratio is 1.0 to 1).

307. *See Punitive Award Survey*, *supra* note 306, at 3-4, 7.

308. Domke on Commercial Arbitration (Wilner ed. 1994).

309. *See* Siconolfi, *supra* note 109, at C1.

First you argue: Get everyone into arbitration because it's going to be great for the claimant, and it's going to be great for us, it's going to cut our costs, we're not going to have to worry about large awards, and now you're picking away at that order and want to get rid of these punitive damage awards and want to limit the claimant on what he can recover. I think the perception of that is going to be very harmful.

MR. THOMPSON: We've been talking today about a process that really had its origins as a lay process, if I may use that term. It is becoming more and more legalistic largely because, I think, the law has become more sophisticated. But my question doesn't really concern the whole issue of punitive damages as much as an ancillary, but very important, issue that was raised in the *Wall Street Journal* article that Paul referred to, and that was a quote by Arthur Levitt, in which he said, "I have a problem with agreements that couch prohibitions in [small] type, or in language that is incomprehensible to investors."[310]

I was listening to Paul discuss the three points. He was having to really put an interpretation on at least two of those points, and Paul is an attorney and also very familiar with this area; but, put yourself in the shoes of the average investor who is trying to understand what it is that he or she is agreeing to.

My question is, don't we have an obligation to translate this if it's going to become more legalistic—to translate this into language the average investor can understand?

PROF. COFFEE: We might ask the SEC here. Is that part of their responsibility?

MR. COLBY: I think if it continues, we absolutely have an obligation to make it comprehensible.

MR. LEVINE: May I just say, not speaking for either my firm or for the industry, that I don't believe the way to go is to go back to court. And I don't believe the way to go is to have a voluntary access to court.

The one thing that hasn't been articulated, I think part of the mix, Gus, is there has to be some discipline brought into the process of bringing the claim if you permit it into the arbitration arena because a lot of our concern is not the actual filing. I think the statistics speak for themselves.

It is the overhang in terms of dealing with the resolution of the matter before the arbitration's filed that creates the problem. And the reason you haven't seen a lot of arbitration punitive demands more than you already have is because there's been the *in terrorem* effect of all this discussion as to whether *Garrity* applies, where it goes. Essentially there's a lot of noise in the system.

I believe that you have to resolve this issue in the arbitration process, not by going to court, because if you go to court, I think you will

310. *Id.* (alteration in original).

both hurt clients and hurt the firms for different reasons. So, I think this is the right forum to resolve this issue, not the judicial forum.

PROF. COFFEE: You said there has to be some discipline, presumably on the plaintiffs' side, in deciding what claim to bring forward. Isn't there some discipline in the fact that the plaintiff has to go out and find an attorney who either will take a fee or will have to appraise this as having a worthwhile contingent prospect?

MR. LEVINE: You are one of the most sophisticated lawyers I know, John, and that question scares me because if the solicitation throughout the country by plaintiffs' lawyers or firms is any indication of that discipline, I haven't seen it in terms of the ability of that kind of *in terrorem* effect in terms of bringing a claim.

What I was looking for is, there's got to be some mechanisms to either strike a frivolous action or penalize the party who brought it, as there is in the judicial context. If you don't have that, it is very easy to bring the case, especially if you don't award fees to losers or winners, as you heard.[311] If there's no process for disciplining that, then there's no incentive not to do it at all. That's what I am concerned about in the process.

MS. MASUCCI: One of the problems that we've been facing as administrators is the folklore surrounding any award of punitive damages.

In our discussions with the industry, they really would want to know more or less why arbitrators in a particular case issued a punitive damage award. You know, cite the facts as well as the law that gave them that authority.

The folklore that I'm talking about is that in the past there have been some cases where arbitrators just said we're awarding $20,000 in punitive damages, and the speculation afterwards was, well this really wasn't a punitive damage case. They wanted to give the claimant his or her attorneys' fees.

At the NASD, we've been encouraging arbitrators, in view of the fact that there's no requirement to do so, to identify facts that will specify their authority to award punitive damages so that the parties don't have to guess the authority relied upon.

It's likely that with arbitrators explaining more in their decisions, the parties will become more confident that arbitrators are making the proper decisions on a case-by-case basis.

PROF. COFFEE: You want a common law system with precedents. I don't know if we have more comments on this issue. We do have, in

311. *See* Stephen Labaton, *Committee Approves Bill To Set Limits On Lawsuits*, N.Y. Times, Feb. 24, 1995, at A15 (reporting that the House Judiciary Committee approved tort reform legislation that would provide for a loser-pays rule, as well as imposition of mandatory fines on lawyers for bringing frivolous lawsuits).

this procedure, the contemplation that there will be questions. Do people have specific questions?

MS. ZUCHLEWSKI: Professor, before we leave the topic of punitive damages, we spent a considerable amount of time this morning talking about employment discrimination disputes going to arbitration.[312] I would like to point out, because we've been talking about business disputes throughout this discussion, that there is the issue of punitive damages in the specific context of employment discrimination cases.

I think what's happened here is that the industry is taking the anomalous position of saying people can get their rights adequately adjudicated in the arbitration forum, but not permitting them to seek the punitive damages that they would be entitled to if they went to federal court under the Civil Rights Act of 1991, which I note has a cap on damages.[313]

So, when you think about punitive damages, although the employment discrimination cases are a very small minority of the cases at this point, that issue at least should be considered and be addressed.

MR. MADDOX: I'm from Indianapolis, and I'm a director of the Public Investors Arbitration Bar Association.

I want to comment on one of Gus' comments that he thinks that, perhaps after we get the *Mastrobuono* decision, the punitive damages discussion might go differently than it has the last three years. I guess I can't share that optimism presently. I'm relatively new to the debate. I've sat through a couple of the sort of SRO-brokered discussions that were held this past year. And it became clear to me right

312. *See supra* pp. 1613-42.

313. Civil Rights Act of 1991, 42 U.S.C. § 1981a(b)(3), "Damages in cases of intentional discrimination in employment," provides:

(b) Compensatory and Punitive Damages

* * *

(3) Limitations

The sum of the amount of compensatory damages awarded under this section for future pecuniary losses, emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and other nonpecuniary losses, and the amount of punitive damages awarded under this section, shall not exceed, for each complaining party—

(A) in the case of a respondent who has more than 14 and fewer than 101 employees in each of 20 or more calendar weeks in the current or preceding calendar year, $50,000;

(B) in the case of a respondent who has more than 100 and fewer that 201 employees in each of 20 or more calendar weeks in the current or preceding calendar year, $100,000; and

(C) in the case of a respondent who has more than 200 and fewer than 501 employees in each of 20 or more calendar weeks in the current or preceding calendar year, $200,000; and

(D) in the case of a respondent who has more than 500 employees in each of 20 or more calendar weeks in the current or preceding calendar year, $300,000.

42 U.S.C. § 1981a(b)(3) (Supp. V 1993).

out of the gate that there's no consensus on the industry side about this issue.

Some individuals, some decision-makers in certain firms, have drawn the line in the sand, have just said no punitive damages under any circumstances. Others seem to be a little more willing to talk about meeting halfway.

On the plaintiffs' bar side, it is the same thing. Some of our members really feel that there should be an unfettered right to punitive damages, and others are willing to talk about meeting halfway.

In the environment, though, even if one of those sides actually wins one of those extreme points with the *Mastrobuono* decision, I guess, I don't see what's necessarily going to change that environment.

I do echo the concern that removing punitive damages from the arbitration process could deteriorate the process even further. You know, I see punitive damages as just a component of a bigger problem, really, and that is the exportation of New York law to the rest of the country. When we sit in arbitration hearings in Indianapolis, and we look out the window, we don't see Manhattan—we see the Indiana statehouse.

Our general assembly and our court system have developed a certain body of law for our residents, which the vast majority of the public customers that I've encountered don't waive in any sort of an informed or knowledgeable fashion when they decide to do business with a brokerage firm.

The barriers that we see the industry attempt to erect, through the New York choice-of-law clause, and the result in different remedies, a different remedy for those investors in arbitration, as opposed to what they would get at the courthouse, I think is a real problem.

If those barriers at some point become too high and the potential remedies become so different, then I think the public may ultimately get strong enough to do something about possibly getting back into the courthouse.

In addition, the punitive damage issue, if it goes against the public investor, is going to add to those barriers.

But, Gus, I wish I could share your optimism about how those discussions are going to go after *Mastrobuono*, but it's been one of the toughest issues I've ever encountered. With one side potentially winning after *Mastrobuono*, I just don't see it changing.