COMMENT

MASTROBUONO v. SHEARSON LEHMAN HUTTON, INC.: ANOTHER PIECE OF THE FEDERAL ARBITRATION ACT POLICY PUZZLE

I. INTRODUCTION

Contracting parties expect that the terms stated in their agreement will define their contractual relationship and control the ultimate disposition of their contract. In a commercial setting, parties may agree to arbitrate contractual disputes in accordance with the rules of either the American Arbitration Association (AAA), the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), or the National Association of Securities Dealers (NASD).1 These arbitration agreements fall within the scope of the Federal Arbitration Act (FAA).2

A problem arises when an arbitration provision contained within the parties' contract is ambiguously drafted. The parties may disagree regarding the extent of the authorized arbitral power. Specifically, they may dispute whether an arbitrator may award punitive damages under the contract. The ambiguity is created when the arbitration agreement contains two provisions that each provide for a different rule regarding

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The NASD, NYSE, and AMEX are called self-regulatory organizations (SROs) and provide the codes, rules, and forums for a majority of securities arbitrations. Davis, supra, at 67. The AAA is an independent, not-for-profit organization that also provides a commercial arbitration forum. Id. at 66; Katzler, supra, at 155 n.17.

2Efron, supra note 1, at 334; see also 9 U.S.C. §§ 1-208 (1994).
punitive damages.\textsuperscript{3} One provision will incorporate the arbitration guidelines of the AAA, NYSE, AMEX, or NASD, which allow arbitrators to award punitive damages.\textsuperscript{4} Another provision, however, will invoke a controlling state law, such as New York, which restricts an arbitrator from awarding punitive damages.\textsuperscript{5} In cases that involve ambiguous arbitration provisions, the issue becomes whether a court will uphold an arbitrator's punitive damage award.

The federal courts have interpreted these ambiguous arbitration agreements differently. The Second and Seventh Circuit Courts of Appeal have ordered an arbitrator's award of punitive damages to be vacated.\textsuperscript{6} The First, Eighth, and Eleventh Circuit Courts of Appeal have upheld an arbitrator's punitive damage award.\textsuperscript{7} The Supreme Court recently resolved the conflict among the circuit courts in \textit{Mastrobuono v. Shearson Lehman Hutton, Inc.}\textsuperscript{8} The Court examined conflicting provisions in a client agreement signed by the Mastrobuonos when they opened a securities trading account with Shearson Lehman Hutton, Inc.\textsuperscript{9} The arbitration provision of the agreement referenced the NASD, NYSE, and AMEX rules, but the agreement also contained a choice-of-law provision stating that the agreement would be governed by the laws of

\textsuperscript{3}See infra note 97 for an example of a typical ambiguous arbitration provision contained within a standard-form "customer agreement."

\textsuperscript{4}One example of a rule allowing arbitral punitive damages is Rule 41(e) of the NASD Arbitration Procedure. See infra note 212 and accompanying text.

\textsuperscript{5}See Garrity v. Stuart, 353 N.E.2d 793 (N.Y. 1976) (holding that arbitration panels are not authorized to award punitive damages); see also Davis, supra note 1, at 62-65 (discussing generally the Garrity case and noting that "it has drawn much criticism for its refusal to allow arbitrators to award punitive damages, even when the parties have so agreed"); Thomas J. Stipanowitch, \textit{Punitive Damages in Arbitration}, Garrity v. Lyle Stuart, Inc. Reconsidered, 66 B.U. L. Rev. 953, 959 (1986) (criticizing Garrity as "an anomaly, frustrating the goals of fairness and finality that are the essence of arbitration").


\textsuperscript{7}Lee v. Chica, 983 F.2d 883, 888 (8th Cir. 1993) (upholding arbitral authority to award punitive damages); Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056 (9th Cir. 1991) (holding that an award of punitive damages was within an arbitration panel's authority); Raytheon Co. v. Automated Business Sys. Inc., 882 F.2d 6, 12 (1st Cir. 1989) (noting that arbitral punitive damages can be awarded despite a lack of express mention of such relief in parties' agreement); Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1387 (11th Cir. 1988) (noting that arbitrators have authority to award punitive damages).

\textsuperscript{8}115 S. Ct. 1212 (1995).

\textsuperscript{9}Id. at 1214.
the State of New York. The Court held that this ambiguous arbitration provision, and others similarly drawn, reflects an intent of the parties to allow for arbitral punitive damages.

This comment examines several key aspects surrounding the Court's decision. Part II discusses relevant sections of the FAA and reviews the three major areas of case law that form the background for the Court's holding. Section A traces the judicial development of the federal policy under the FAA. Section B examines case law regarding the FAA's pre-emption powers over restrictive state laws. Section C explores the conflict among the circuit courts, and the different approaches employed by the courts that have handled the issue. Part III analyzes the Mastrobuono controversy at the district court, circuit court, and Supreme Court levels and includes an examination of Justice Thomas's dissent. Finally, Part IV critically examines how Mastrobuono fits into the federal policy of the FAA, and how the decision has influenced recent circuit court and state court decisions.

II. BACKGROUND

Prior to the enactment of the Federal Arbitration Act in 1925, courts believed that binding agreements to arbitrate disputes were against public policy because they were "attempts to oust courts of jurisdiction." The FAA was designed to change this common law opposition toward arbitration and to place arbitration agreements "upon the same footing

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10 Id. at 1214-17.
11 Id. at 1219.
as other contracts."\textsuperscript{15} The Act rests on Congress's authority under the commerce clause to enact substantive rules.\textsuperscript{16} Section 2 is the Act's substantive command, providing that written arbitration agreements involving "commerce"\textsuperscript{17} or maritime transactions will be "valid, irrevocable, and enforceable" to resolve disputes.\textsuperscript{18} Section 3 authorizes

\textsuperscript{15}Scherk v. Alberto-Culver Co., 417 U.S. 506, 511 (1974) (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2 (1924)). Scherk was decided by the Supreme Court 21 years after Wilko v. Swan. See supra note 13 and accompanying text. In Scherk, the Supreme Court analyzed a breach of warranty claim arising from an international commerce transaction involving the sale of trademarks in certain cosmetic goods. \textit{Id.} at 508. The contract contained an arbitration provision whereby both parties agreed to arbitrate all disputes arising from the trademark sale. \textit{Id.} The buyer, Alberto-Culver, believed that some of the seller's representations regarding its trademarks constituted securities fraud and brought suit in federal court, also seeking a preliminary injunction to stay any arbitration proceedings. \textit{Id.} The Supreme Court denied the injunction and allowed for arbitration, stating that the invalidation of such an agreement . . . would not only allow [Alberto-Culver] to repudiate its solemn promise [to arbitrate] but would, as well, reflect a "parochial concept that all disputes must be resolved under our laws and in our courts . . . . We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts."

\textit{Id.} at 519 (citations omitted). The Supreme Court distinguished this case from \textit{Wilko}, allowing arbitration in a securities context, because, "based on the uncertainty of international contracts and the attendant risk, arbitration was an appropriate forum for protecting the parties' statutory rights."


First, Congress may have been issuing a procedural edict under its article III powers directed only to cases in the federal court system. Second, Congress may have enacted a rule of substantive federal law under article III directed only to cases before the federal courts. Third, acting pursuant to its powers over admiralty and commerce, Congress may have made substantive federal law binding on both federal and state courts.

\textit{Id.} at 1314-15 (footnotes omitted).

The Court resolved this problem in Prima Paint Corp. v. Flood & Conklin Manufacturing Co. by holding that the FAA was promulgated pursuant to Congress's powers to regulate maritime and interstate commerce. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 405 (1967).

\textsuperscript{17}9 U.S.C. \S 1 (1988) (defining "commerce" as interstate or foreign commerce).

\textsuperscript{18}9 U.S.C. \S 2 (1988). Section 2 states:
courts of the United States to stay their proceedings pending arbitration,\textsuperscript{19} while section 4 authorizes the issuance of an order to compel arbitration when a federal district court has jurisdiction over the underlying suit.\textsuperscript{20} Section 10(a)(4) is an important part of the FAA in that it permits a court to vacate awards in which the "arbitrators exceeded their powers."\textsuperscript{21}

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

\textit{Id.}\textsuperscript{19} U.S.C. § 3 (1988). Section 3 states:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

\textit{Id.}\textsuperscript{20} U.S.C. § 4 (1994). Section 4 states in pertinent part:

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28 [28 U.S.C.S. § 1 (1994)] in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement.

\textit{Id.}\textsuperscript{21} U.S.C. § 10(a)(4) (1994). Section 10(a)(4) states that a district court may vacate an award "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award upon the subject matter submitted was not made." \textit{Id.}

Section 10 also permits an arbitration award to be vacated:

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

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

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

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

\textit{Id.} § 10. Judicial review of an arbitration award under the FAA is considered "extremely narrow." Barton, \textit{supra} note 13, at 1555. Some commentators argue that, as a result of this
The FAA is an anomaly in the area of federal-court jurisdiction. Although it creates a body of federal substantive law that establishes and regulates the duty to respect agreements to arbitrate, it does not create independent federal jurisdiction. This means that under section 4, a court can only issue an order compelling arbitration when there is diversity of citizenship or "some other independent basis" for federal jurisdiction. To fully comprehend and appreciate the Court’s decision in Mastrobuono, an examination of three areas of case law involving the FAA is required.

A. Federal Policy Under the FAA

The Supreme Court shaped and developed the federal policy which defines the FAA through several key cases decided in the 1980s. The first such case was Moses H. Cone Memorial Hospital v. Mercury Construction Corp., decided in 1983. Moses involved a contract between a contractor and a hospital. The contract required the contractor to construct additions to the hospital building and contained a provision indicating that disputes were to be resolved by arbitration. When a dispute arose over extended overhead and increased construction costs, the hospital filed an action in the state court seeking a declaratory judgment that the contractor was not entitled to arbitration. The contractor filed suit in federal district court for an order compelling arbitration pursuant to section 4 of the FAA. The hospital filed a motion to stay the federal court action pending resolution of the state

limited judicial review, arbitrators should not have the power to award punitive damages. See, e.g., Darren C. Blum, Punitive Power: Securities Arbitrators Need It, 19 NOVA L. REV. 1063, 1075-76 (1995) (noting that limited judicial review is a "popular argument" among those who oppose arbitrators having the authority to award punitive damages); see also infra note 245 for a discussion on the potential due process implications that arguably arise as a result of the limited judicial review of arbitration decisions.

24Moses, 460 U.S. at 25 n.32.
25See supra notes 20-24 and accompanying text; infra notes 26-65 and accompanying
text.
27Id. at 4.
28Id.
29Id. at 6-7.
30Moses, 460 U.S. at 7.
The district court granted the stay order of the federal proceeding pending resolution of the state action. The Fourth Circuit overturned the district court's stay order. The United States Supreme Court granted certiorari and affirmed the Fourth Circuit's decision, thereby resolving the concurrent forums issue. More importantly, however, the Court announced that a federal policy favoring arbitration underlies the FAA. The Court held that section 2 is "a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary." Section 2 effectively "create[d] a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." Furthermore, the Court held that the FAA should resolve any doubts over the scope of arbitrable issues in favor of arbitration, including contract interpretation, allegations of waiver, delay, or any similar defense to arbitrability. This substantive rule of law is binding on any federal or state court in an arbitration case under the FAA. The Court decided that the district court's refusal to

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31 Id.
32 Id. (stating that the court took this action "because the two suits involved the identical issue of the arbitrability of Mercury's claims").
35 Moses, 460 U.S. at 29. Justice Brennan delivered the opinion of the Court. Id. at 4. The Court used the Colorado River balancing test to determine if the hospital made a showing of exceptional circumstances to warrant a stay. Id. at 19; see also Colorado River Water Conservation Dist. v. United States, 424 U.S. 800, 817-20 (1976) (articulating the factors of the test). The Court decided against the stay after considering such factors as convenience of the forum, avoidance of piecemeal litigation, and the order in which jurisdiction was obtained by the concurrent forums. Moses, 460 U.S. at 19.
36 Moses, 460 U.S. at 24.
37 Id.
38 Id. The Court provided Prima Paint Corp. as an example. In that case, one of the parties to a contract containing an arbitration clause alleged "that there had been fraud in the inducement of the entire contract." Id. The Court held that the language of the FAA warranted a conclusion that the fraud issue was arbitrable, even though there were no allegations of fraud regarding the arbitration clause particularly. Prima Paint Corp., 388 U.S. at 402-04.
39 Moses, 460 U.S. at 24-25. Justice Brennan wrote:

The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.

Id.
40 Feldman, supra note 14, at 699.
proceed contradicted the congressional intent that the FAA move parties with arbitrable disputes out of court and into arbitration as quickly and as easily as possible.\textsuperscript{41}

The Court continued to define the federal policy under the FAA a year later in \textit{Dean Witter Reynolds Inc. v. Byrd}.\textsuperscript{42} In Byrd, a stockbroker and his client had a written agreement to arbitrate any disputes that might arise out of the client's account.\textsuperscript{43} When the value of the account rapidly declined by more than $100,000, the client filed an action in the district court alleging violations of the Securities Exchange Act of 1934 and of various state-law provisions.\textsuperscript{44} Dean Witter filed a motion to compel arbitration of the state claims under the parties' agreement.\textsuperscript{45} The district court denied the motion, and the Ninth Circuit affirmed.\textsuperscript{46} The Supreme Court, granting \textit{certiorari},\textsuperscript{47} and reversing the lower court's decision, held that the FAA was designed "to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate."\textsuperscript{48} The FAA does not provide for "discretion by a district court, but instead mandates that district courts \textit{shall} direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed."\textsuperscript{49}

In 1985, the Court decided \textit{Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.}\textsuperscript{50} This case involved an international arbitration agreement between an automotive manufacturer and an automotive dealer.\textsuperscript{51} \textit{Mitsubishi} has a significant place in defining the FAA federal policy because the Court, relying on its prior decision in \textit{Moses}, declared that "as with any other contract, the parties' intentions control, but those intentions are generously construed as to the issues of arbitrability."\textsuperscript{52}

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\textsuperscript{41}\textit{Moses}, 460 U.S. at 22.
\textsuperscript{42}70 U.S. 213 (1985).
\textsuperscript{43}Id. at 215.
\textsuperscript{44}Id. at 214.
\textsuperscript{45}Id. at 215.
\textsuperscript{46}Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552, 554 (9th Cir. 1984) (explaining that the court took this action because "the pendent and federal claims depend[ed] on substantially the same factual issues").
\textsuperscript{48}Byrd, 470 U.S. 219-20. Justice Marshall, who delivered the opinion for the Court, noted that "[t]he legislative history of the Act establishes that the purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate." \textit{Id.} at 219.
\textsuperscript{49}Id. at 218. The Court explained that the language of the Act mandated the enforcement of arbitration agreements unless there is an independent basis for revocation of the contract. \textit{Id.}
\textsuperscript{50}473 U.S. 614 (1985).
\textsuperscript{51}Id. at 617.
\textsuperscript{52}Id. at 626. Shortly after the Court's decision in \textit{Mitsubishi}, the Court decided two cases which overruled Wilko and allowed for arbitration in the securities context. \textit{See}
Until the Supreme Court decided *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University* in 1989, the federal policy favoring arbitration, developed through *Moses* and its progeny, seemed fairly well settled. *Volt*, however, took a major step away from the existing federal policy because it was the first Supreme Court decision to hold that enforcement of the substantive rights created under the FAA could be "hindered, delayed, or even denied by state law."

In *Volt*, the Board of Trustees of Leland Stanford Junior University (Stanford) entered into a contract with Volt Information Sciences, Inc. (Volt), under which Volt was to install a series of electrical systems on the Stanford campus. The contract contained a provision wherein all disputes between the parties would be subject to arbitration. The contract also contained a choice-of-law clause, which provided that the contract would be "governed by the law of the place where the Project is located." Accordingly, California law would control. When a dispute over compensation for extra work arose, Volt made a formal demand for arbitration. Stanford responded by filing an action in state court against Volt alleging fraud and breach of contract. Volt petitioned the court to compel arbitration, and Stanford moved for a stay. The state court granted Stanford's motion and denied Volt's motion.

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Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 484 (1989) (holding that the 1933 Act and 1934 Act should be "construed harmoniously" and, thus, arbitration agreements under § 12(2) of the 1933 Act must be upheld); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 234-38 (1987) (holding that domestic securities claims brought under § 10(b) of the 1934 Act may be arbitrable); Joseph T. McLaughlin, *Symposium on Business Dispute Resolution: ADR and Beyond: Arbitrability: Current Trends in the United States*, 59 Alb. L. Rev. 905, 909-12 (1996) (discussing Rodriguez and Shearson, and noting that with these cases the Supreme Court overruled *Wilko* and held that "purely domestic securities disputes may now be arbitrated"); Barton, *supra* note 13, at 1541-42 (stating that "the Court decisively overruled *Wilko*" and held that 1933 Act and 1934 Act claims could be sent to arbitration).

*See also supra* notes 26-52 and accompanying text.


*Volt*, 489 U.S. at 470.

*Id.*

*Id.* (citation omitted).

*Id.*

*Volt*, 489 U.S. at 470.

*Id.* at 471. Stanford also sought to receive payment from other construction companies with whom it did not have arbitration agreements.
California Court of Appeal, affirming the lower court, held that the contract’s choice-of-law provision displayed an intent by the parties to incorporate California law.\textsuperscript{64} Under the California law, a stay pending resolution of related litigation between a party bound by an arbitration agreement and third parties that are not bound is permitted.\textsuperscript{65} After the California Supreme Court declined to review the case, the Supreme Court granted \textit{certiorari}.\textsuperscript{66}

The Supreme Court affirmed the lower court decision.\textsuperscript{67} After reviewing its holdings in Moses and its progeny, the Court noted that "due regard must be given to the federal policy favoring arbitration."\textsuperscript{68} Further, the Court held that when resolving disputes over the scope of ambiguous arbitration provisions, courts should find in favor of arbitration.\textsuperscript{69} However, the Court stated, "There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate."\textsuperscript{70} The FAA analogizes privately negotiated agreements to arbitrate to contracts, and indicates that therefore the agreements should be enforced in conformity with their provisions.\textsuperscript{71} The Supreme Court indicated that the California Court of Appeal did not offend the federal policy of the FAA set forth in Moses and its progeny by interpreting the choice-of-law provision to mean that the parties intended the California rules of arbitration to apply to their agreement.\textsuperscript{72}

The Volt holding appears to have undermined the Moses holding that issues regarding the scope of the arbitration agreement should be resolved in favor of arbitration.\textsuperscript{73} The decision led one commentator to write that "[t]he Volt holding is incoherent, unprecedented, and contrary to the language, legislative history and purpose of the federal arbitration

\textsuperscript{64}\textit{Volt}, 489 U.S. at 471.
\textsuperscript{65}Board of Trustees v. Volt Info. Sciences., 240 Cal. Rptr. 558, 561 (Ct. App. 1987).
\textsuperscript{66}\textit{Volt}, 489 U.S. at 472-73.
\textsuperscript{67}Id. at 473, 479. The Court affirmed 6-2; Justice O'Connor did not participate in the decision. \textit{Id.} at 469.
\textsuperscript{68}Id. at 475-76.
\textsuperscript{69}Id. at 476.
\textsuperscript{70}\textit{Volt}, 489 U.S. at 476.
\textsuperscript{71}Id. at 478. Justice Rehnquist, writing for the majority, also noted that "[t]he FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration." \textit{Id.} at 477. For further discussion on the Volt Court pre-emption position, see \textit{infra} text accompanying note 95.
\textsuperscript{72}\textit{Volt}, 489 U.S. at 476. The Supreme Court deferred to the California court’s interpretation of the contract provision. \textit{Id.}
\textsuperscript{73}\textit{Moses}, 460 U.S. at 24-25.
statute." Other commentators believe that strict adherence to Moses and its progenies' liberal rule of construction should have led the Volt Court to compel arbitration, as well as pre-empt the California law, because it denied the federal policy favoring arbitration.

B. The Pre-emption Cases

Although the FAA does not contain an express pre-emption provision, pre-emption is a popular argument in cases where there is a state law or arbitration-prejudiced statute that conflicts with the pro-arbitration federal policy of the FAA. Several important cases address this issue.

In Southland Corp. v. Keating, a dispute arose between Southland, the owner and franchisor of 7-Eleven stores, and 7-Eleven franchisees. Each agreement between franchisor and franchisee contained an arbitration clause requiring that disputes arising out of the agreement be settled in arbitration. The franchisees, alleging, inter alia, a violation of the California Franchise Investment Law (FIL), brought an action in California Superior Court. The California Superior Court declined to compel arbitration on the claims brought under the FIL. The California Court of Appeal decided to compel arbitration, but its decision was reversed by the California Supreme Court. The California Supreme Court determined that the FIL required a judicial forum for resolution of all franchise claims and that the FIL did not contravene the

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74 See Jiang, supra note 55, at 236 (footnotes omitted). The commentator opined further that Volt's holding undermines Moses and its progeny and would lead to uncertainty in cases involving the federal arbitration right. Id. at 236-37.
75 See Efron, supra note 1, at 340.
76 See generally Stephen J. Ware, Punitive Damages in Arbitration: Contracting Out of Government's Role in Punishment and Federal Preemption of State Law, 63 Fordham L. Rev. 529, 544-58 (1994) (discussing generally the proposition that "[b]ecause the FAA requires enforcement of arbitration agreements, any state law purporting to limit freedom of contract with respect to the arbitrability of punitive damages conflicts with the FAA and is preempted by it").
78 Id. at 3-4.
79 Id. at 4.
80 Id. Specifically, the franchisees alleged a violation of the FIL's disclosure requirements. Id. The FIL provides: "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." Cal. Corp. Code § 31,512 (West 1977).
82 Keating v. Superior Ct., 167 Cal. Rptr. 481, 495 (Cl. App. 1980).
83 Keating v. Superior Ct., 645 P.2d 1192, 1203-04 (Cal. 1982).
The United States Supreme Court reversed in part the California Supreme Court decision. The Supreme Court held that the Franchise Investment Law directly conflicted with section 2 of the FAA and hence violated the Supremacy Clause. The Court declared that the policy of favoring arbitration set forth in the FAA demands that disputes between parties who contracted to arbitrate must be so resolved and that this policy in effect prohibits states from requiring judicial resolution of such disputes.

Three years later in *Perry v. Thomas*, the Court continued to clarify the extent of the FAA's pre-emption powers. In *Perry*, a dispute regarding compensation on the sale of securities led an employee, Thomas, to bring an action against Kidder, Peabody and Co., his former employer, even though his employment contract contained a provision requiring arbitration. Thomas brought his claim under section 229 of the California Labor Code. The defendants filed a motion to compel arbitration in California Superior Court. Ultimately, the Supreme Court addressed the case and held that the federal policy places section 2 of the FAA in "unmistakable conflict" with section 229 of the California Labor Code and found that section 229 was pre-empted under the Supremacy Clause.

The Court recognized that in cases such as *Southland* and *Perry*, the FAA pre-empts state laws requiring a judicial forum for the resolution of claims that the contracting parties agreed to resolve by arbitration. Even as recently as 1995, in *Allied-Bruce Terminix Cos. v. Dobson*, the Court has affirmed this position.

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84 *Southland*, 465 U.S. at 5.
85 *Id.* at 6.
86 *Id.* at 10.
87 *Id.* The Court went on to cite § 2 and concluded that § 2 demands enforcement of agreements to arbitrate. *Id.*
89 *Id.* at 484-85.
90 *Id.* at 485. Section 229 provides that employee wage collection actions may be maintained without regard to the existence of any private agreement to arbitrate. *Id.* at 486.
91 *Id.* at 485.
92 *Perry*, 482 U.S. at 491.
93 115 S. Ct. 834, 836-37 (1995). In *Allied-Bruce*, a dispute arose between an exterminator and a homeowner, who were bound by a contract containing an arbitration provision stating that any controversy would be resolved by arbitration. *Id.* at 837. Upon finding their home infested with termites, the homeowners filed suit in state court; the exterminator's motion to stay for arbitration pursuant to their contract and § 2 of the FAA was denied. *Id.* The Alabama Supreme Court affirmed the lower court based on an Alabama statute that placed limitations on predispute arbitration agreements, the Supreme Court granted certiorari and reversed the state courts. *Id.* The Court held that under the FAA, states cannot
In 1989, the Volt Court attempted to define the extent of the FAA's pre-emption power.94 After acknowledging the holdings in Southland and Perry, the Court said:

[It does not follow that the FAA prevents the enforcement of agreements to arbitrate under different rules than those set forth in the Act itself. Indeed, such a result would be quite inimical to the FAA's primary purpose of ensuring that private agreements to arbitrate are enforced according to their terms. Arbitration under the Act is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit. Just as they may limit by contract the issues they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted. Where ... parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA, even if the result is that arbitration is stayed where the Act would otherwise permit it to go forward.95

C. Circuit Courts' Differing Views on Arbitral Punitive Damages

Problems arise in cases subject to the FAA that involve a contract containing both an arbitration provision and a choice-of-law provision, and where the controlling state law of the agreement will not allow an arbitration panel to award punitive damages.96 A choice-of-law provision can generally be found in a "customer agreement."97 Under these

refuse to enforce an arbitration clause of a contract while holding that its other terms (regarding price, service, etc.) are fair because this places agreements to arbitration on lower ground, thus undermining the congressional intent behind the Act. Id. at 843. For further commentary on Allied-Bruce, see Donald E. Johnson, Recent Decision: Has Allied-Bruce Terminix Cos. v. Dobson Exterminated Alabama's Anti-Arbitration Rule?, 47 ALA. L. REV. 577 (1996).

94 Volt, 489 U.S. at 479.
95 Id. (citation omitted).
97 Efron, supra note 1, at 333. The typical "customer agreement" may state: This agreement ... shall be governed by the laws of the State of New York. ... [A]ny controversy arising out of or relating to the [customers'] accounts ... shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Board of
circumstances, if the arbitration provision is ambiguous as to arbitral authority to award punitive damages and an arbitration panel awards punitive damages to one party, the other party will generally move to vacate the award in district court.98 The vast majority of these choice-of-law provisions select New York law to control.99 This is because the leading New York decision in this area, Garrity v. Stuart, maintains that arbitration panels are not authorized to award punitive damages.100 The circuit courts have split in the resolution of this issue; some circuit courts have vacated arbitral punitive damage awards, while others have upheld them.101

1. Punitive Damages Vacated

The Seventh Circuit addressed the issue of whether punitive damages can be vacated in states in which arbitration panels cannot award punitive damages in Pierson v. Dean, Witter, Reynolds, Inc.102 The Piersons opened an account with Dean Witter for security trading and signed a customer agreement containing both an arbitration provision and a choice-of-law provision.103 The choice-of-law provision made New York law controlling.104 Consequently, an arbitration panel would have been unable to grant punitive damages to the Piersons.105 When problems occurred with their account, the Piersons filed suit in the federal district court alleging both federal and state common law claims.106 Dean Witter

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Directors of the New York Stock Exchange, Inc., as the [customer] may elect.

Id. at 333 n.4.

98See, e.g., Mastrobuono, 115 S. Ct. at 1215.
99Efron, supra note 1, at 333.
100353 N.E.2d 793, 794 (N.Y. 1976). The rationale behind the Garrity rule is that the ability to award punitive damages is a state function. Ware, supra note 76, at 530. This school of thought relies on the notion that punitive damages are not designed to compensate the individual plaintiff. Richard A. Epstein, Cases and Materials on Torts 798-99 (5th ed. 1990). Punitive damages have a quasi-criminal nature and thus their role is to deter actors, as well as to punish deliberate or flagrant wrongs. Id. at 799. Punitive damages are generally viewed as a public function; they are an expression of society's outrage against heinous conduct. Ware, supra note 76, at 547. Allowing parties to contractually agree to the possibility of arbitral punitive damages essentially privitizes this public function. Id.
101See supra notes 6-7. At least one commentator believes that the circuit courts' differing holdings are due in part to the confusion and conflict about the federal policy under the FAA after the Volt decision. See Efron, supra note 1, at 340.
102742 F.2d 334 (7th Cir. 1984).
103Id. at 336.
104Id. at 336.
105Id. at 338.
requested that the district court compel arbitration, but the district court denied the motion. In so holding, the district court said that the Piersons did not knowingly waive their right to the availability of punitive damages because nothing regarding punitive damages was specifically mentioned in the agreement.

The Seventh Circuit, while recognizing some potential unfairness to the Piersons, reversed the district court decision. The Seventh Circuit held that it would not change the plain wording of the arbitration clause to the Piersons' advantage merely because the Piersons may not have fully understood the potential ramifications, including losing the possibility of obtaining punitive damages. The Seventh Circuit believed it was obliged to honor the choice-of-law provision, agreed upon by the parties, under which no punitive damages could be awarded by an arbitration panel.

Some of the Seventh Circuit's reasoning was followed in the Second Circuit. Barbier v. Shearson Lehman Hutton, Inc. also involved interpretation of a customer agreement containing both an arbitration clause calling for arbitration according to the rules of the NASD or the NYSE and a New York choice-of-law provision. After an arbitration panel awarded compensatory and punitive damages in favor of the Barbiers, the district court granted the Barbier's motion to confirm the award and denied Shearson's motion to vacate.

Relying on Volt, the Second Circuit reversed the decision of the district court and vacated the award, holding that the FAA requires enforcement of all private agreements to arbitrate according to their terms. The Second Circuit looked to the intentions of the parties and found that "[i]t is apparent from the inclusion of the choice-of-law provision that the parties intended to be bound by Garrity." The court

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107 Id. at 504.
108 Id.
109 Pierson, 742 F.2d at 340.
110 Id. at 338. The court also indicated that although the Piersons may have been unaware of the ramifications, they were aware that New York law controlled and that by agreeing to arbitrate, they were giving up the right to a jury trial. Id. at 339.
111 Id. at 339.
113 Id. at 119. This case involves the exact same standard-form Customer's Agreement and arbitration provision as Mastrobuono. Mastrobuono, 115 S. Ct. at 1217. The irony will become obvious.
115 Id. at 164.
116 Barbier, 948 F.2d at 122-23.
117 Id. at 122.
concluded that the parties' intentions must control, meaning that arbitral
awards of punitive damages were prohibited.\textsuperscript{118}

2. Punitive Damages Upheld

In \textit{Bonar v. Dean Witter Reynolds, Inc.}, the Eleventh Circuit
interpreted a customer agreement that contained both a New York choice-
of-law provision and an arbitration provision calling for all disputes to be
settled by arbitration according to the rules of the AAA or the NYSE.\textsuperscript{119}
Customers of Dean Witter sought arbitration before an AAA panel for
several violations of state and federal laws and were awarded punitive
damages.\textsuperscript{120} The Eleventh Circuit noted the conflict within the customer
agreement.\textsuperscript{121} On one hand, Rule 43 of the AAA rules provided 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."\textsuperscript{122} This,
according to the court, authorized the arbitration panel to award punitive
damages.\textsuperscript{123} On the other hand, the agreement incorporated a New York
choice-of-law provision prohibiting arbitral punitive damage awards.\textsuperscript{124}
The Eleventh Circuit resolved the issue in favor of allowing awards of
arbitral punitive damages.\textsuperscript{125} In fashioning its holding, the court
ultimately relied on the rule set forth in \textit{Moses} that precedence is given
to contract provisions allowing arbitral punitive damages.\textsuperscript{126} A choice-of-
law provision in a contract governed by the FAA "merely designates the
substantive law" that will control in the event of a dispute.\textsuperscript{127} Thus, the
authority of arbitrators to grant punitive damages was not affected.\textsuperscript{128}

\begin{footnotesize}
\textsuperscript{118}Id. The Second Circuit continued this line of reasoning in Fahnestock & Co. v.
Waltman, 935 F.2d 512, 519 (2d Cir. 1991). The court held that arbitral punitive damages
were properly vacated pursuant to the \textit{Garrity} rule, despite an arbitration provision providing
for NYSE rules to control the proceedings. \textit{Id.} at 518. The court did note in dicta, however,
that "an agreement between the parties specifically to award punitive damages may well have
dictated a different outcome." \textit{Id.}
\textsuperscript{119}935 F.2d 1378, 1386 (11th Cir. 1988). Any award made by the arbitrators was to
be final, and any court having proper jurisdiction could enter the award. \textit{Id.}
\textsuperscript{120}Id. at 1380-81.
\textsuperscript{121}Id. at 1386.
\textsuperscript{122}Id. (citation omitted).
\textsuperscript{123}Bonar, 835 F.2d at 1386.
\textsuperscript{124}Id. at 1387.
\textsuperscript{125}Id. The court indicated that the addition of the choice-of-law provision in the
contract did not mean that punitive damages were no longer an available remedy. \textit{Id.}
\textsuperscript{126}Id.
\textsuperscript{127}Bonar, 835 F.2d at 1386.
\textsuperscript{128}Id.
\end{footnotesize}
The First Circuit sustained an arbitration award of punitive damages in *Raytheon Co. v. Automated Business Systems.* 129 This case did not involve a customer agreement or New York law. 130 Instead, *Raytheon* involved a contract containing a general arbitration clause stating that arbitration would be conducted according to the AAA rules, and that California law would govern the interpretation of the agreement. 131 The arbitration clause did not specifically provide for the award of punitive damages. 132 When a dispute arose between the parties to the contract, it was submitted to arbitration, and an arbitration panel awarded punitive damages to the injured party. 133

On appeal, the First Circuit decided whether the arbitration clause in the parties’ contract empowered the arbitral panel to award punitive damages. 134 The court noted that commercial arbitration cases have employed three different approaches when dealing with arbitral awards of punitive damages. 135 First, several states, such as New York, prohibited arbitration panels from awarding punitive damages. 136 Second, some courts allowed a commercial arbitrator to award punitive damages only where the parties’ agreement specifically provided for such damages. 137 Third, as was stated in *Bonar,* if the parties’ agreement incorporated the AAA Rules, an arbitration panel could award punitive damages despite the lack of an express mention of such relief. 138 The court adopted the third position, a rule favoring the arbitrability of punitive damage claims. 139 Also, the court noted that parties desiring to exclude arbitral punitive damages could do so by drafting explicit agreements to that effect. 140

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129882 F.2d 6, 12 (1st Cir. 1989).
130Id.
131Id. at 6-7.
132Id. at 6. In fact, Raytheon, the defendant in the original action, informed the arbitrators that issues of punitive damages were not subject to arbitration. Id. at 7.
133Raytheon, 882 F.2d at 6. The court noted that the arbitral panel gave no explanation as to how it made its determinations regarding what types of damages to award and what dollar amount to award. Id. at 7.
134Id. at 9.
135Id. at 11.
136Id. The court noted that under *Garrity,* the award of punitive damages is a function of the state that cannot be applied in private disputes. Id.
137Raytheon, 882 F.2d at 11.
138Id.
139Id. at 12.
140Id. The court noted in this case that “no such exclusion from the general language of the arbitration clause exists,” thus punitive damages could be granted. Id.
In *Lee v. Chica,* the Eighth Circuit also upheld arbitral authority to award punitive damages. The customer agreement at issue contained a Minnesota choice-of-law provision and a provision calling for arbitration according to the AAA rules. The district court vacated an arbitral award of punitive damages after determining that Minnesota law did not allow such awards. On appeal, the Eighth Circuit held that "[w]hen the choice-of-law provision in an arbitral clause incorporates the rules of the AAA ... arbitrators may grant any remedy or relief including punitive damages." Although Minnesota law did not allow an arbitral award of punitive damages, the court stated that when parties have agreed to arbitrate, subject to the rules of the AAA, and the issues involved are related to interstate commerce, the rules of the AAA are bolstered by the rules of the FAA.

III. ANALYSIS

*Mastrobuono v. Shearson Lehman Hutton, Inc.* sought to resolve the conflict that had developed in the federal circuit courts. Not only did the Supreme Court have to decide how to reconcile the competing arbitration and choice-of-law provisions contained within the parties' customer agreement, it also had to consider the disruption *Volt* created in the line of cases defining the federal policy underlying the FAA.

A. Facts

Mr. and Mrs. Mastrobuono opened a securities trading account with Shearson Lehman Hutton Inc. in 1985. Nick DiMinico, a vice president for Shearson, served as the registered representative for the Mastrobuonos' account. When the Mastrobuonos opened their account, they signed a standard-form client agreement. The language contained

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141983 F.2d 883, 884 (8th Cir. 1993).
142Id.
143Id. at 885.
144Id. at 887.
145Lee, 983 F.2d at 888.
147Id. at 1214, 1216.
148Id. at 1214.
149Id.
150Mastrobuono, 115 S. Ct. at 1214.
within paragraph 13 of the client agreement is at the center of this controversy.\textsuperscript{151}

Paragraph 13 of the agreement contained both an arbitration provision and a choice-of-law provision.\textsuperscript{152} It stated that any controversy relating to the Mastrobuonos' account would be settled by arbitration and would be governed by New York law.\textsuperscript{153}

The Mastrobuonos closed their account with Shearson in 1987.\textsuperscript{154} In January 1989, they filed a lawsuit in the United States District Court for the Northern District of Illinois against Shearson and Nick DiMinico. They alleged that their account had been mismanaged and subjected to "unauthorized trading, churning, and margin exposure."\textsuperscript{155} The Mastrobuonos raised both federal claims and state statutory and tort claims.\textsuperscript{156} They also requested punitive damages on the state claims.\textsuperscript{157} Pursuant to paragraph 13 of the agreement, Shearson moved to compel arbitration before the National Association of Security Dealers (NASD).\textsuperscript{158} The district court granted the motion.\textsuperscript{159}

\textsuperscript{151}Id.
\textsuperscript{152}Id. Paragraph 13 of the client’s agreement stated:

This agreement shall inure to the benefit of your [Shearson’s] successors and assigns[,] shall be binding on the undersigned, my [petitioner’s] heirs, executors, administrators and assigns, and shall be governed by the laws of the State of New York. Unless unenforceable due to federal or state law, any controversy arising out of or relating to [my] accounts, to transactions with you, your officers, directors, agents and/or employees for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc and/or the American Stock Exchange Inc. as I may elect. If I do not make such election by registered mail addressed to you at your main office within 5 days after demand by you that I make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof. This agreement to arbitrate does not apply to future disputes arising under certain of the federal securities laws to the extent it has been determined as a matter of law that I cannot be compelled to arbitrate such claims.

\textsuperscript{153}Id. at 1216-17 n.2.
\textsuperscript{154}Id. at 1214-15.
\textsuperscript{155}Mastrobuono, 115 S. Ct. at 1214.
\textsuperscript{156}Mastrobuono, 20 F.3d at 715.
\textsuperscript{157}Id.
\textsuperscript{158}Id.
\textsuperscript{159}Id.
\textsuperscript{159}Mastrobuono, 20 F.3d at 715.
The Mastrobuonos filed an amended complaint at arbitration again requesting punitive damages on the state law claims.\textsuperscript{160} Hearings for the claims were held in August and September 1992.\textsuperscript{161} On the final day of the hearings, Shearson submitted a memorandum regarding claims for punitive damages arguing that based on the client agreement between the parties, the arbitration panel was not authorized to award punitive damages.\textsuperscript{162} On October 13, 1992, the arbitration panel executed their award.\textsuperscript{163} The Mastrobuonos received $159,327 in compensatory damages and $400,000 in punitive damages.\textsuperscript{164}

Shearson subsequently filed a motion in the district court to vacate the damage award because it believed that New York law was the governing law of the client agreement and, therefore, an arbitral award of punitive damages was precluded.\textsuperscript{165} The Mastrobuonos moved to confirm the punitive damage award or, in the alternative, requested that either the district court award the punitive damages directly or that they (petitioners) should be afforded a separate trial on the punitive damages claims alone.\textsuperscript{166}

B. The District Court Decision

The district court denied the Mastrobuonos' motion and vacated the award of punitive damages.\textsuperscript{167} The court was required to interpret the parties' intended meaning of paragraph 13.\textsuperscript{168} Relying on the reasoning set forth in \textit{Barbier}, the court held that the customer of a brokerage firm who signs an agreement that is expressly governed by New York law has contractually waived any potential award of punitive damages in arbitration.\textsuperscript{169} The court recognized \textit{Garrity} as the controlling New York decision in this area.\textsuperscript{170}

\begin{itemize}
\item \textsuperscript{160}\textit{Id.}
\item \textsuperscript{161}\textit{Id.} The hearings were held before a panel of three arbitrators. \textit{Id.}
\item \textsuperscript{162}\textit{Id.} On appeal of the district court decision, the Mastrobuonos argued that Shearson waived its objections to the arbitral punitive damages because they did not raise the issue until the proofs in arbitration had closed. \textit{Id.} at 716. The Seventh Circuit rejected this argument because it felt that the Mastrobuonos had sufficient time to respond to Shearson's late submission and were not prejudiced in any way. \textit{Id.}
\item \textsuperscript{163}\textit{Mastrobuono,} 812 F. Supp. at 846.
\item \textsuperscript{164}\textit{Id.}
\item \textsuperscript{165}\textit{Mastrobuono,} 20 F.3d at 715.
\item \textsuperscript{166}\textit{Id.} at 715-16.
\item \textsuperscript{167}\textit{Mastrobuono,} 812 F. Supp. at 848-49.
\item \textsuperscript{168}\textit{Id.} at 846-47.
\item \textsuperscript{169}\textit{Id.} at 847.
\item \textsuperscript{170}\textit{Id.}
\end{itemize}
The Mastrobuonos argued that because the FAA was designed to "overrule the judiciary's longstanding refusal to enforce agreements to arbitrate," it should pre-empt the application of Garrity.171 The Mastrobuonos relied on the holdings in Perry and Southland for support of their argument.172 The district court was not persuaded.173 Relying on Volt, the court stated that the FAA does not create any independent right to arbitrate.174 As a consequence, "enforcing an arbitration agreement's choice-of-law provision in accordance with the terms of that agreement is fully consistent with the goals of the FAA."175 The liberal policy favoring arbitration does not provide any sound basis for ignoring choice-of-law provisions in arbitration agreements.176 In the same way parties may limit the issues to be arbitrated, so too may they specify the rules that will govern the arbitration.177

The court held:

Where the parties have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA. Because the Mastrobuonos agreed to arbitrate their dispute in accordance with the laws of the State of New York, and because the Agreement does not explicitly or by incorporation authorize the award of punitive damages, the remedies available to them are limited by the Garrity rule. This limitation gives effect to the contractual rights and expectations of the parties and does not violate the policies codified in the FAA.178

The district court then vacated the punitive damage award pursuant to section 10 of the FAA.179

171 Mastrobuono, 812 F. Supp. at 847 (quoting Byrd, 470 U.S. at 219-20). This indicates that the Mastrobuonos relied on the pre-Volt understanding of the FAA's federal policy, as set forth in Moses and its progeny. Id.
172 Id. These cases indicate that the FAA serves to pre-empt state laws that preclude parties from arbitrating certain issues. Id.
173 Id.
174 Id.
175 Mastrobuono, 812 F. Supp. at 847.
176 Id.
177 Id. at 848.
178 Id.
179 Mastrobuono, 812 F. Supp. at 848. See supra note 21 and accompanying text for a discussion of § 10 of the FAA.
Finally, the court addressed the issue of whether the Mastrobuonos could have the district court award the punitive damages or, in the alternative, whether the Mastrobuonos could have a trial on the punitive damage claims alone.\textsuperscript{180} The court held that it would not disregard the policies of the FAA by awarding "damage that are precluded by the parties’ privately negotiated arbitration agreement."\textsuperscript{181} The court also held that the Mastrobuonos could not separately litigate the punitive damages claim as both Illinois and New York law preclude a separate cause of action for punitive damages.\textsuperscript{182}

C. The Circuit Court Decision

The Seventh Circuit affirmed the district court decision granting the motion to vacate the award of punitive damages.\textsuperscript{183} Following their prior holding in \textit{Pierson}, the court interpreted the contract as incorporating New York law and held that the arbitration panel could not award punitive damages.\textsuperscript{184}

The Mastrobuonos offered three basic arguments on appeal.\textsuperscript{185} First, they claimed that the district court violated the standard of review for an arbitration decision imposed by the FAA.\textsuperscript{186} Second, the

\textsuperscript{180}\textit{Mastrobuono}, 812 F. Supp at 848.
\textsuperscript{181}Id.
\textsuperscript{182}Id.
\textsuperscript{183}\textit{Mastrobuono}, 20 F.3d at 719.
\textsuperscript{184}Id. at 718-19. The court stated, "We resolve any apparent conflict between New York law and the NASD rules in favor of New York law, the generally applicable law of the agreement." \textit{Id.} at 718.
\textsuperscript{185}See id. at 716-19. The Seventh Circuit would not entertain pre-emption as a possible fourth argument for the Mastrobuonos. \textit{Id.} at 716-17. The court stated that FAA pre-emption of the \textit{Garrity} rule was not an issue because the parties agreed to arbitrate all of their controversies under New York law. \textit{Id.} at 717. The parties adopted \textit{Garrity} as binding by choosing New York law without omitting New York arbitration rules. \textit{Id.}
\textsuperscript{186}See id. at 716. The court, explaining why the district court’s review of arbitration decision was not in error, stated that "§ 10(a)(4) of the FAA permits a court to vacate an award ‘[w]here the arbitrators exceeded their powers.’" \textit{Id.} (quoting 9 U.S.C. § 10(a)(4) (1988)). The Seventh Circuit noted that the "arbitrator’s errors of law and contract construction are normally unreviewable under this standard." \textit{Id.} The court, however, held that the district court properly reviewed the arbitration award under this standard because once the district court determined that arbitral punitive damages were not permitted under the parties agreement, an award of arbitral punitive damages was a clear case of an arbitration panel exceeding its powers. \textit{Id.}

After granting \textit{certiorari}, the Supreme Court stated that "[b]ecause our disposition would be the same under either a de novo or deferential standard, we need not decide in this case the proper standard of a court’s review of an arbitrator’s decision as to the arbitrability of a dispute or as to the scope of an arbitration." \textit{Mastrobuono}, 115 S. Ct. at 1215 n.1. The
Mastrobuonos argued that the choice-of-law provision referred to and encompassed all New York law, including its conflict-of-laws principles.\(^{187}\) If the district court had applied the New York choice-of-law principles, the case would have been determined pursuant to Illinois law, under which arbitrators are not precluded from awarding punitive damages.\(^{188}\) The court quickly rejected both of these arguments.\(^{189}\)

Finally, the Mastrobuonos argued that the district court misinterpreted paragraph 13 of the customer agreement.\(^{190}\) The Mastrobuonos believed that the arbitration rules of the NASD, incorporated by reference in paragraph 13 of the agreement, expressly authorized arbitrators to award punitive damages.\(^{191}\) The Seventh Circuit examined three sets of rules: the NASD Code of Arbitration Procedures, the NASD Arbitrator's Manual, and the NASD Rules of Fair Practice.\(^{192}\) The court held that based on the parties' agreement, New York law applied regardless of the chosen arbitral rules.\(^{193}\)

The Mastrobuonos further argued that a conflict between the NASD rules and New York law should be decided in favor of arbitration and the award of punitive damages.\(^{194}\) The court held, as in \textit{Volt}, that it would resolve any apparent conflict in favor of New York law, as endorsed in the client agreement.\(^{195}\) In fashioning its holding, the

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\(^{187}\)Mastrobuono, 20 F.3d at 718.

\(^{188}\)Id. This argument was also unsuccessful. Under Illinois conflict law, the parties' expressly chosen law controls as long as it is not "dangerous, inconvenient, immoral, [or] contrary to the public policy' of Illinois," and that it bears a relationship to either the parties or the transaction. \textit{Id.} at 719 (quoting McAllister v. Smith, 17 Ill. 328, 333 (1856)). "[T]he public policy considerations must be strong and of a \textit{fundamental} nature to justify overriding the chosen law of the parties." \textit{Id.} (quoting Potomac Leasing Co. v. Chuck's Pub., Inc., 509 N.E.2d 751, 754 (1987)). The Seventh Circuit held that there were no such fundamental public policy considerations against the \textit{Garrity} rule. \textit{Id.} Also, New York law is reasonably related to the parties because it is Shearson's principle place of business. \textit{Id.}

\(^{189}\)Id. at 716-19.

\(^{190}\)Id. at 717.

\(^{191}\)Mastrobuono, 20 F.3d at 717. This was similar to the successful arguments utilized by parties in \textit{Bonar, Raytheon}, and \textit{Lee}.

\(^{192}\)Id. at 717-18.

\(^{193}\)Id. at 717.

\(^{194}\)Id. at 718.

\(^{195}\)Mastrobuono, 20 F.3d at 718.
Seventh Circuit reviewed the Court's statement in Moses that "the scope of arbitrable issues should be resolved in favor of arbitration." The Seventh Circuit explained that it distinguished between the scope of arbitrable issues and the availability of certain remedies. The court held that the client agreement did not withhold certain issues from arbitration, as is proper under the FAA, but simply limited the scope of available remedies.

D. The Supreme Court Decision

The Mastrobuonos asked the Supreme Court to hold that the FAA pre-empts New York's prohibition against arbitral awards of punitive damages because the Garrity rule is a "vestige of the 'ancient' judicial hostility to arbitration." Justice Stevens, in delivering the majority opinion, wrote that while the Congress passed the FAA to overcome courts' refusals to enforce agreements to arbitrate, "the pro-arbitration policy does not operate without regard to the wishes of the contracting parties." After reviewing its holdings in Allied-Bruce, Southland, and Perry, the Court stated:

[If contracting parties agree to include claims for punitive damages within the issues to be arbitrated, the FAA ensures

\[\text{\textsuperscript{198}}\text{Id. (quoting Moses, 460 U.S. at 24-25).} \]

\[\text{\textsuperscript{197}Id.} \]

\[\text{\textsuperscript{196}Id. Prior to the Supreme Court's decision in Mastrobuono, at least one commentator believed that the Seventh Circuit's decision was the "correct conclusion." Davis, supra note 1, at 91-92. Professor Davis supported the Seventh Circuit's decision by writing that:} \]

\[\text{\textsuperscript{195}Garrity prohibits arbitrators from awarding punitive damages. Section 21(f)(4) [of the NASD Rules of Arbitration] prohibits any limitation of remedies. The two are incompatible. To determine which controls, the court must evaluate which of the two parties intended to govern. By arbitrating before the NASD, the parties impliedly adopt NASD rules \ldots. However arbitration is contractual, and within the confines of public policy, the parties may agree on any provisions they please. They may vary or altogether abandon the governing rules of the arbitration organization hearing their dispute \ldots. The choice-of-law clause [in the parties' agreement] is an express agreement to submit to New York law, including the Garrity rule. The Garrity rule is incompatible with rule 21(f)(4) and therefore displaces it.} \]

\[\text{\textsuperscript{194}Id. (citations omitted).} \]

\[\text{\textsuperscript{193}Mastrobuono, 115 S. Ct. at 1215 (quoting Allied-Bruce, 115 S. Ct. at 838).} \]

\[\text{\textsuperscript{192}Id. at 1214. Justice Stevens was joined in his majority opinion by Chief Justice Rehnquist and Justices O'Connor, Scalia, Kennedy, Souter, Ginsburg, and Breyer. Id.} \]

\[\text{\textsuperscript{191}Id. at 1216.} \]
that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration. Thus, the case ... comes down to what the contract has to say about the arbitrability of petitioners' claim for punitive damages.202

The Court reduced the issue to contract interpretation.203 Therefore, the Court's task was to analyze paragraph 13 of the client agreement to determine if the arbitration and the choice-of-law provisions expressed the intent of the parties to either include or exclude punitive damage claims.204 If the parties' intent was to include punitive damages within their arbitration agreement, the FAA would ensure enforcement of the agreement by its terms, despite the Garrity rule.205

The Court stated that when viewed in isolation, the choice-of-law provision could reasonably be read as a mere substitute for the conflict-of-law analysis otherwise necessary in determining which law applies to the parties' contractual relationship.206 Further, even if the provision was more than simply a substitute for ordinary conflict-of-law analysis, it might only intend to include "New York's substantive rights and obligations, and not the State's allocation of power between alternative tribunals."207 The Court declared that the provision itself is not "an unequivocal exclusion of punitive damage claims."208

The Court then considered the arbitration provision and concluded that when read separately, it steadfastly implied that an arbitration award of punitive damages was appropriate.209 It clearly authorized arbitration in accordance with the NASD, NYSE, or the American Stock Exchange rules.210 The arbitration panel proceeded under the NASD rules.211 The Court looked to Rule 41(e) of the NASD Code of Arbitration Procedure

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202 Id.
203 See Mastrobuono, 115 S. Ct. at 1215-23. The Court stated that it would be reviewing the federal court's interpretation of the contract de novo. Id. at 1217 n.4.
204 Id. at 1217. The court stated: "To ascertain whether Paragraph 13 expresses an intent to include or exclude such claims, we first address the impact of each of the two relevant provisions, considered separately. We then move on to the more important inquiry: the meaning of the two provisions taken together." Id.
205 Id. The Court indicated that if there was no contractual evidence of an intent to exclude punitive damages, the FAA would pre-empt Garrity.
206 Id.
207 Mastrobuono, 115 S. Ct. at 1217.
208 Id.
209 Id. at 1218.
210 Id. at 1218 & n.5.
211 Mastrobuono, 115 S. Ct. at 1218.
which states that arbitrators may award "damages and other relief" and said that while this is not a clear authorization of punitive damages, the provision seems broad enough to at least contemplate such a remedy.\textsuperscript{212} Additionally, the Court pointed out that the manual provided to NASD arbitrators contains a provision that states arbitrators may consider punitive damages as a remedy.\textsuperscript{213}

The Court then read both of the provisions together in order to determine the intent of the parties.\textsuperscript{214} The Court indicated that the choice-of-law clause introduced "an ambiguity into an arbitration agreement that would otherwise allow punitive damage awards."\textsuperscript{215} The Court construed the ambiguity against Shearson for three reasons.\textsuperscript{216}

First, based on Moses and its progeny, when a court interprets the provisions in an agreement covered by the FAA, "due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration."\textsuperscript{217} Second, the Court declared that common law contract interpretation mandates that ambiguous language contained within a contract be construed against the interest of the drafting party.\textsuperscript{218} Here, Shearson

\textsuperscript{212}Id. The rule states in pertinent part:

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

\textsuperscript{213}\textit{Mastrobuono}, 115 S. Ct. at 1218. The manual provides in part: "The issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy." NASD, ARBITRATOR'S MANUAL 26 (1992).

\textsuperscript{214}Id.

\textsuperscript{215}Id. at 1218-19.

\textsuperscript{216}Id. at 1218 (quoting Volt, 489 U.S. at 476). While the Court takes this quote from the Volt opinion, it is merely a restatement of the federal policy developed under Moses and its progeny. Volt, 489 U.S. at 475-76. The Volt Court did not rely on the Moses principle to fashion its holding; it merely stated the Moses principle in order to distinguish it and show that it was not in conflict with their holding. Id. at 476.

\textsuperscript{217}\textit{Mastrobuono}, 115 S. Ct. at 1219. The Court stated that it looked to Illinois and New York state law for relevant authority. Id. at 1219 n.9. See, e.g., Graff v. Billet, 477 N.E.2d 212, 213-14 (N.Y. 1984) (indicating that ambiguities must be resolved against the preparer); United States Fire Ins. Co. v. Schnackenberg, 429 N.E.2d 1203, 1205 (Ill. 1981) (explaining that uncertainty as to the meaning of disputed language must be resolved against the party preparing it); RESTATEMENT (SECOND) OF CONTRACTS § 206 (1979) (explaining that
drafted the agreement and should not be permitted to reap the benefit of the doubt.\footnote{Mastrobuono, 115 S. Ct. at 1219.} Finally, the court embraced another fundamental principle of contract interpretation which purports that a document should be read to give effect to all its provisions and render them consistent with one another.\footnote{Id. See, e.g., Crimmins Contracting Co. v. City of N.Y., 542 N.E.2d 1097, 1100 (N.Y. 1989) (emphasizing the importance of reading clauses of a contract in the context of the entire contract); Halas v. McCasky, 470 N.E.2d 960, 964 (Ill. 1984) (stating that provisions of an instrument are not to be read in isolation); RESTATEMENT (SECOND) OF CONTRACTS § 203(a) & cmt. b (1979) (explaining that a reasonable interpretation based on all the terms of the contract is preferred).}

The Court held that the best way to reconcile the two provisions of paragraph 13 would be to read the choice-of-law clause to pertain to substantive rules of New York law but not to encompass the rules which restrict the power of arbitrators.\footnote{Mastrobuono, 115 S. Ct. at 1219.} Consequently, the choice-of-law provision would govern the parties' rights and duties, and the arbitration clause would control the arbitration.\footnote{Id.} The Court indicated that Shearson's view, positing two conflicting clauses (one allowing punitive damages and one not) was untenable.\footnote{Id.} Based on these three points, the Court held that the Seventh Circuit misinterpreted the client agreement and that the arbitral award allowing punitive damages should be enforced as it was within the scope of the contract.\footnote{Id.; but see supra note 198 and accompanying text for a contrasting interpretation of the Mastrobuono agreement.}

E. The Dissent

Justice Thomas was the lone dissenter.\footnote{Mastrobuono, 115 S. Ct. at 1214.} He believed the choice-of-law provision in the Mastrobuonos' client agreement was not functionally distinguishable from the one used in Volt and, therefore, the Garrity rule should have controlled the parties' arbitration agreement.\footnote{Id. at 1219. The majority responded to Thomas's argument by drawing a distinction between the standards of review used in Volt and Mastrobuono. Id. at 1217 n.4. In Mastrobuono, the majority stated they were reviewing the federal court’s interpretation of the customer agreement de novo. Id. However, as the majority points out, the Court in Volt deferred to the state court's construction of the parties' contract because "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review." Id. (quoting Volt, 489 U.S. at 474).}
Thomas stated that the majority's argument is exactly the type of argument that the Volt Court rejected.\textsuperscript{227} In Thomas's opinion, two of the majority's assertions were fashioned to defend the majority's departure from the holding in Volt.\textsuperscript{228}

Thomas initially focused on the majority's claim that the choice-of-law provision introduced an ambiguity into the arbitration agreement, and that it conflicted with the arbitration clause's reference to the NASD rules that, according to the majority, authorized an arbitral award of punitive damages.\textsuperscript{229} Specifically, the majority looked to Rule 41(e) of the NASD Code of Arbitration Procedure to support their contention.\textsuperscript{230} Thomas, however, interpreted Rule 41(e) differently from the majority.\textsuperscript{231}

Justice Thomas believed that Rule 41(e) did not define the powers of the arbitrator, but only described the form in which the arbitrators must announce their decision.\textsuperscript{232} He stated that a specific rule authorizing punitive damages does not exist.\textsuperscript{233} Thomas indicated that "[t]he Code certainly does not require that arbitrators be empowered to award punitive damages; it leaves to the parties to define the arbitrator's remedial powers."\textsuperscript{234}

Justice Brennan, a dissenter in Volt, stated that
the Court overlooks well-established precedent to the effect that, in order to guard against arbitrary denials of federal claims, a state court's construction of a contract in such a way as to preclude enforcement of a federal right is not immune from review in this Court as to its "adequacy." Volt, 489 U.S. at 482 (Brennan, J., dissenting). See also Memphis Gas Co. v. Beeler, 315 U.S. 649, 654 (1942) (emphasizing that the contract's meaning and effect should be decided by state courts); Indiana ex rel. Anderson v. Brand, 303 U.S. 95, 100 (1938) (giving respectful consideration to the state's highest court, but stating that the Supreme Court must decide if a contract was made); Appleby v. City of N.Y., 271 U.S. 364, 379 (1926) (explaining that the Supreme Court must decide if a contract has been made). Otherwise, "federal rights could . . . be nullified by the manipulation of state law." Volt, 489 U.S. at 484 (quoting Herbert Wechsler, The Appellate Jurisdiction of the Supreme Court: Reflections of the Law and the Logistics of Direct Review, 34 WASH. & LEE L. REV. 1043, 1052 (1977)).

One commentator recently observed that the majority's distinction may result in inconsistent results between federal and state courts that "Congress would not have wanted." Efron, supra note 1, at 348 (quoting Allied-Bruce, 115 S. Ct. at 836).

\textsuperscript{227}See Mastrobuono, 115 S. Ct. at 1221 (Thomas, J., dissenting). Justice Thomas specifically referred to the majority's argument that the New York choice-of-law provision contained within the parties' agreement only goes to substantive state law.

\textsuperscript{228}Id.

\textsuperscript{229}Id.

\textsuperscript{230}Id.

\textsuperscript{231}Mastrobuono, 115 S. Ct. at 1221 (Thomas, J., dissenting).

\textsuperscript{232}Id.

\textsuperscript{233}Id.

\textsuperscript{234}Id. at 1221-22.
Second, the majority found evidence of the parties' intention for arbitral punitive damages in the manual provided to NASD arbitrators. Thomas disagreed, declaring that the manual was not an official NASD document; it was neither promulgated or adopted by the NASD nor was it used in the Mastrobuonos' arbitration proceeding. Thomas felt that the manual's purpose was to provide tips and advice to the arbitrator overseeing the proceedings. According to Thomas, it was not a statement of "'rules,' in the sense contemplated by paragraph 13." Also, Thomas believed that the part of the manual referring to punitive damages only defined such damages and did not state that the arbitrator has the power to award them.

Justice Thomas dissented because he interpreted paragraph 13, and the parties' intentions, differently from the majority. Based on his examination of the client agreement, the choice-of-law provision, the NASD Code of Procedure, and the SICA manual, Justice Thomas believed that the parties intended to have New York law control the arbitration, as well as preclude arbitral awards of punitive damages.

In conclusion, Justice Thomas noted the limited precedential value of the majority's decision. He indicated that the majority's decision would be of limited precedential value because it was applicable to "this specific contract and to no other.

IV. Evaluation

The decision in Mastrobuono calls for an evaluation in two areas. Initially, an evaluation of how Mastrobuono fits into the line of

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235 Mastrobuono, 115 S. Ct. at 1222 (Thomas, J., dissenting).
236 See id.
237 Id. Justice Thomas notes that the manual was compiled by members of the Securities Industry Conference on Arbitration (SICA) as a supplement to the Uniform Code of Arbitration, which, in his opinion, the parties did not adopt in paragraph 13. Id.
238 Id.
239 Mastrobuono, 115 S. Ct. at 1222 (Thomas, J., dissenting).
240 Id. See supra note 213 for the relevant text of the manual.
241 Mastrobuono, 115 S. Ct. at 1222 (Thomas, J., dissenting).
242 Id. at 1223.
243 Id.
244 Id. Whether or not this was an accurate prediction is one of the issues examined in the evaluation portion of this comment.
245 This comment does not address the due process implications of limited judicial review of an arbitrator's award in light of the Mastrobuono decision. For an in-depth discussion of this issue, see Ware, supra note 76, at 558-72. See also Burton, supra note 13,
1980s cases that shaped the federal policy of the FAA is warranted. Surely scholars and commentators who were unhappy with the Court's decision in Volt had high hopes that Mastrobuono would shift the trend back to the precedent set in Moses and its progeny. Further, an analysis is warranted as to whether the decision in Mastrobuono is truly limited to the specific contract between these two parties as Justice Thomas believed, or whether the Mastrobuono Court's holding will carry a strong precedential value. An examination of subsequent federal and state case law influenced by Mastrobuono will be undertaken to provide an answer.246

A. How Does Mastrobuono Fit into the Federal Policy?

Mastrobuono's holding is straightforward. The Court will enforce the parties' intentions as determined by an interpretation of the client agreement.247 If the parties have expressly agreed to allow arbitral awards of punitive damages, the Court will enforce this agreement.248 If the parties expressly contract for no arbitral punitive damages, this will also be enforced.249 If there is an ambiguous arbitration provision, where there is no express declaration of the parties' intentions, and the court finds that the parties agreed to include arbitral punitive damage awards in their arbitration agreement, the FAA ensures that the agreement will be enforced, despite state law to the contrary.250 Despite this clear holding, Mastrobuono does not fall easily into place in the federal arbitration policy continuum.

When Mastrobuono is compared with Moses and its progeny, differences in reasoning are apparent. Moses and its progeny developed and expressly declared a substantive rule of law that the FAA should resolve any doubts over the scope of arbitrable issues in favor of

at 1557-60 (discussing the due process concerns in the review of arbitration awards); Efron, supra note 1, at 348-50 (noting that "an arbitral award of punitive damages may be unconstitutional where the arbitral system lacks adequate due process safeguards"); Mundheim, supra note 1, at 200, 238-42 (arguing that "punitive damages are a necessary component of arbitration in the securities industry, but that, given the requirements of due process, arbitrators should be constrained in their ability to make such awards").

246See discussion infra Part IV.B (examining the decisions in Gateway Technologies, Inc. v. MCI Telecommunications Corp., 64 F.3d 993 (5th Cir. 1995); Davis v. Prudential Sec., Inc., 59 F.3d 1186 (11th Cir. 1995); Kelley v. Michaels, 59 F.3d 1050 (10th Cir. 1995)).

247See supra text accompanying notes 204-05; Mastrobuono, 115 S. Ct. at 1216.

248See supra text accompanying note 205; Mastrobuono, 115 S. Ct. at 1216.

249See supra text accompanying note 205; Mastrobuono, 115 S. Ct. at 1216.

250See supra text accompanying note 206-07; Mastrobuono, 115 S. Ct. at 1216.
This rule was binding on both federal and state courts. While the Mastrobuono Court acknowledged this policy in its decision, the Court did not utilize this "substantive rule of law" in its ultimate holding. The Mastrobuono Court's holding was based on a judicial determination of the parties' intent through interpretation of the client agreement. The Mastrobuono Court ultimately held the way it did because it believed it was acting in line with the parties' intentions, not because of a federal substantive rule requiring courts to favor arbitration.

When Mastrobuono is compared with Volt, differences in reasoning are also readily apparent. The Volt holding, like Mastrobuono, was based on contract interpretation of an agreement containing conflicting arbitration and choice-of-law clauses. The Volt Court took the position that inclusion of a state choice-of-law provision precluding punitive damages was evidence of the parties' intent to prohibit such awards. Faced with the same situation as in Volt, the Mastrobuono Court was not as willing to turn away from the federal policy favoring arbitration. Yet, instead of relying on a federal substantive rule for their holding, the Mastrobuono Court decided that the choice-of-law provision was controlling only in matters of substantive state law, not the relative powers of alternative tribunals. The Court found evidence of the parties' intent to include arbitral awards of punitive damages in the arbitration provision containing references to that power.

Based on these comparisons, it appears that Mastrobuono falls somewhere in the middle of the federal arbitration policy continuum in which Moses and Volt are at the two extremes. While the Mastrobuono Court was unwilling to make a complete return to the substantive policies of Moses and its progeny, the Court did mitigate some of the harsher
aspects of *Volt* by not allowing the inclusion of a choice-of-law provision to undermine the federal policy favoring arbitration.\(^{261}\)

### B. The Effects of Mastrobuono in the Circuit Courts

In *Mastrobuono*, the majority states that the pro-arbitration policy of the FAA does not operate without regard to the wishes of the contracting parties.\(^{262}\) The decision rested on what the parties agreed to regarding punitive damages, as evidenced by their written agreement.\(^{263}\) In fact, the main thrust behind the majority’s decision to uphold the arbitral punitive damage award was a determination of the parties’ intentions through an examination of paragraph 13 of the customer agreement.\(^{264}\)

In his dissent, Justice Thomas noted that the majority’s decision should only apply to the *Mastrobuono*’s specific contract and the specific circumstances which surrounded it.\(^{265}\) He indicated that the majority’s decision is "limited and narrow."\(^{266}\) It follows that Justice Thomas might reasonably believe that in another situation, factually similar to that in *Mastrobuono*, the Court could interpret the parties’ intentions through

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\(^{261}\) *Id.* at 1219. For another commentator’s analysis of the status of the FAA federal policy after *Mastrobuono*, see Joshua M. Barrett, Note, *Federal Arbitration Policy After Mastrobuono v. Shearson Lehman Hutton, Inc.*, 32 *WILLAMETTE L. REV.* 517, 535-36 (1996) (commenting that three possible conclusions can be drawn from *Mastrobuono*: first, that the court is reverting back to its pre-*Volt* policy of preventing states from regulating arbitration; second, that *Mastrobuono* is limited to its facts and has no effect on *Volt*; and finally, that *Volt* and *Mastrobuono*, when read together, indicate that the Court will offer greater deference to state statutes that foster the FAA federal policy, when evaluated under the standards for contract interpretation set forth in *Moses*).

\(^{262}\) *Id.* at 1216.

\(^{263}\) *Mastrobuono*, 115 S. Ct. at 1216.

\(^{264}\) *Id.* at 1218.

\(^{265}\) *Id.* at 1223 (Thomas, J., dissenting); *but see* Paul Lansing & John D. Bailey, *The Future of Punitive Damage Awards in Securities Arbitration Cases After Mastrobuono*, 8 *DEPAUL BUS. L.J.* 201, 220 (1996). Lansing & Bailey state that Justice Thomas’s prediction lacks foundation, for there is nothing in the Court’s opinion restricting the decision solely to the Mastrobuono’s Client Agreement . . . . Any client agreement which specifies arbitration under NYSE . . . [or] NASD, . . . and contains a choice-of-law provision, which would prohibit arbitral, punitive damage awards, creates ambiguity, and adjudicators should resolve the ambiguity against the drafter. Given the prevalence of standard form agreements prepared by securities brokers, the *Mastrobuono* decision is certain to extend far beyond the facts of this case.

*Id.; but see infra* note 292 and accompanying text for why this type of "objective" application of *Mastrobuono* may not be controlling in a state court analysis of a similar contract.

\(^{266}\) *Id.*
that Mastrobuono's holding by focusing on the specific intentions of the parties regarding their specific contract.

In the circuit courts, this issue seems fairly well settled. It appears that the circuit courts are reading Mastrobuono as the final word on an arbitrator's power to award punitive damages. The courts have held that Mastrobuono stands for the proposition that arbitrators have the presumptive power to award punitive damages, and the courts will construe ambiguous arbitration provisions that reference both the NASD rules (or their functional equivalent) and a New York choice-of-law provision to mean that punitive damages may be awarded in arbitration.

For example, six months after Mastrobuono, the Fifth Circuit decided Gateway Technologies v. MCI Telecommunications. The case involved a contract between a subcontractor and a general contractor.

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257 See Mastrobuono, 115 S. Ct. at 1219-23.
258 Id.
259 Id. at 1219.
260 Mitsubishi, 473 U.S. at 626.
261 See National Union Fire Ins. Co. of Pittsburgh, PA v. Belco Petroleum Corp., 88 F.3d 129, 135 (2d Cir. 1996) (finding "no reason not to harmonize the arbitration and choice-of-law clauses precisely as the Court did in Mastrobuono"); Paine Webber Inc. v. Elahi, 87 F.3d 589, 594 (1st Cir. 1996) (holding that the analysis set forth in Mastrobuono is evidence that the choice-of-law provision in the present case is "not an expression of intent to adopt New York caselaw"); Painewebber Inc. v. Bydyk, 81 F.3d 1193, 1200 (2d Cir. 1996) (following Mastrobuono); Gateway Technologies, 64 F.3d at 999 (indicating that arbitrators presumptively have the power to award punitive damages); Davis, 59 F.3d at 1189 (relying on the holding in Mastrobuono); Kelley, 59 F.3d at 1055 (10th Cir. 1995) (following Mastrobuono); Smith Barney Inc. v. Schell, 53 F.3d 807, 809 (7th Cir. 1995) (relying on Mastrobuono).
262 See supra note 271.
263 64 F.3d 993 (5th Cir. 1995).
calling for the installation of a phone system for the Virginia Department of Corrections.\textsuperscript{274} The contract contained an arbitration provision but was silent as to the availability of punitive damages.\textsuperscript{275} After a dispute between the parties was submitted to arbitration, a $2 million punitive damage award was granted to the injured party.\textsuperscript{276} In holding that the arbitrator had the power to impose punitive damages, the Fifth Circuit looked to \textit{Mastrobuono} for guidance and indicated that "the Supreme Court has . . . confirmed that arbitrators \textit{presumptively} enjoy the power to award punitive damages unless . . . the arbitration contract unequivocally excludes punitive damage claims."\textsuperscript{277}

The Tenth and Eleventh Circuits have also dealt with customer agreements similar to the one at the center of the \textit{Mastrobuono} controversy. Both Circuits have upheld arbitral punitive awards.

In \textit{Kelley v. Michaels}, the Tenth Circuit was influenced by \textit{Mastrobuono}'s "rejection" of \textit{Volt}, finding that the choice-of-law provision contained within the agreement did not automatically invalidate an otherwise proper arbitral punitive damage award.\textsuperscript{278} The court strictly followed \textit{Mastrobuono}'s holding that the "best way to harmonize" the arbitration and choice-of-law clauses was to read the choice-of-law provision as dealing only with substantive principles of law and not involving those state laws which limit arbitral power.\textsuperscript{279}

\textsuperscript{274}Id. at 995.
\textsuperscript{275}Id.
\textsuperscript{276}Id. at 995-96.
\textsuperscript{277}\textit{Gateway}, 64 F.3d at 999 (emphasis added). Despite this statement, the Fifth Circuit vacated the punitive damage award. \textit{Id.} at 1001. The court stated that while the arbitrator had the power to impose punitive damages, "his rationale for doing so must be consistent with Virginia law." \textit{Id}. at 999. Under Virginia law, punitive damages are not awarded merely for breach of contract; rather, punitive damages must be based on tort liability. \textit{Id.} Breach of fiduciary duty was the only possible tort in this case, and the court did not find such a breach. \textit{Id.} at 1001. The court indicated that if the state law allowed punitive damages and if the agreement did not expressly prevent such awards, then punitive damages "would have fallen under the arbitrator's broad discretion to decide damages and fashion remedial relief." \textit{Id.} at 998 (citing Executone Info. Sys., Inc. v. Davis, 26 F.3d 1314, 1324-25 (5th Cir. 1994)).
\textsuperscript{278}59 F.3d 1050, 1054-55 (10th Cir. 1995). The issue, as framed by the court, was "whether an arbitral award of damages was contemplated by the parties' agreements." \textit{Id.} at 1054. The choice-of-law and arbitration provisions in \textit{Kelley} were similar to those found in \textit{Mastrobuono}; both chose New York law and both allowed arbitration under the rules of the NASD. \textit{Id.} at 1052.
\textsuperscript{279}Id. at 1055. The court pointed out that "[t]he \textit{Mastrobuono} holding compel[led] our conclusion that the arbitration panel did not exceed its authority by awarding . . . punitive damages despite the choice of New York law." \textit{Id.} The court was bound by precedent to find that "the NASD arbitrator's manual contemplates that they may award punitive damages." \textit{Id.} at 1054 (quoting \textit{Mastrobuono}, 115 S. Ct. at 1218).
In the Eleventh Circuit, the party seeking to vacate arbitral punitive damages in *Davis v. Prudential Securities, Inc.* relied on the *Volt* based argument that where parties select a particular state under their choice-of-law provision, that state's rules governing arbitration should control, even if they are inconsistent with the FAA. The Eleventh Circuit rejected this argument, once again, strictly relying on the holding in *Mastrobuono.*

The Seventh Circuit, which had previously vacated the *Mastrobuono*’s arbitral punitive damage award, also followed the *Mastrobuono* decision in *Smith Barney Inc. v. Schell.* The court held that *Mastrobuono* stood for the proposition "that a contract between a securities brokerage firm and customers permitted an arbitration panel to award punitive damages . . . ." The instant case concerns an arbitration clause identical to the one in *Mastrobuono*. Thus, we must reverse the district court’s injunction prohibiting the arbitration panel from considering claims for punitive damages.

Thus, the circuit courts are not going beyond the reasoning set forth in *Mastrobuono* to determine case-specific party intent. Simply put, the circuit courts are concerned only with the "objective" meaning of the ambiguous contract provision as determined previously by the Supreme Court in *Mastrobuono*. This is not surprising considering that "the interpretation of private contracts is ordinarily a question of state law." Thus, it seems that the best chance for Justice Thomas’s prediction to come true is in the state courts. A state court dealing with an arbitration provision similar to the one in *Mastrobuono* could stand behind the fundamental policy of the FAA, that parties’ intentions should control, and hold that the parties intended to exclude punitive damages from their arbitration agreement.

The most significant result of the circuit courts’ objective application of *Mastrobuono* may be the potential influence it can have on a state court’s interpretation of an ambiguous arbitration clause. A state court that objectively follows the holding set forth in *Mastrobuono* would be in effect disregarding the parties’ intentions as to the arbitration clause.

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280 Id. at 809.
281 *Voit,* 489 U.S. at 474. See also *Mastrobuono,* 115 S. Ct. at 1217 n.4. The majority in *Mastrobuono* reviewed the contract *de novo* because they reviewed a federal court’s interpretation of the contract. *Id.*
This could be considered antithetical to the FAA federal policy of enforcing parties' intended agreements.

In a recent state court decision, Estate of Sandefur v. Greenway,285 the Missouri Court of Appeals addressed an arbitration provision containing clauses referencing both the NASD rules and New York law.286 The court noted that the case was factually similar to Mastrobuono; in fact, Greenway, the company Ms. Sandefur opened a stock trading account with, subsequently became affiliated with Shearson Lehman Brothers, Inc.287 In this case, one of the issues presented to the court was whether, based on the ambiguous arbitration provision, arbitrators may award punitive damages.288 The court held that Mastrobuono was the "coup de grace" of judicial determination on this issue.289 In holding that the punitive damage award against Greenway/Shearson would be upheld, the court stated that "[i]n Mastrobuono, the Supreme Court answered the Shearson appeal at bar by ruling that the arbitrator panel had the power to award punitive damages."290 Except for references to Mastrobuono regarding the likelihood that buyers of securities will know of New York’s prohibition on arbitral punitive damages, the court did not examine the parties’ specific intentions and objectively applied Mastrobuono to the instant case.291

A consequence of the objective application of Mastrobuono’s decision is that it further complicates the pieces of the FAA federal policy puzzle. Not only did the Mastrobuono decision fail to align itself completely with the previous line of FAA jurisprudence, the objective application of the decision serves to underscore the importance of ensuring that parties’ intentions control in their agreements. Because federal courts ordinarily do not interpret private contracts, the burden must fall on the state courts to ensure that the policy of enforcing parties’ intended agreements is continued.292

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286 Id. at 669.
287 Id. at 668-71.
288 Id. at 668.
289 Sandefur, 898 S.W.2d at 671.
290 Id. at 672.
291 Id. at 671-72. The court stated, "As a practical matter, it seems unlikely that petitioners were actually aware of New York’s bifurcated approach to punitive damages, or that they had any idea that by signing a standard-form agreement to arbitrate disputes they might be giving up an important substantive right." Id. (quoting Mastrobuono, 115 S. Ct. at 1219).
292 At least one New York state court, in a case decided subsequent to Mastrobuono, appears not to be influenced by the circuit court’s objective application of Mastrobuono. See Dean Witter Reynolds, Inc. v. Trimble, 166 Misc. 2d 40, 44 (N.Y. Sup. Ct. 1995) (holding in
Despite this potential erosion of one theoretical aspect of the FAA federal policy, a majority of the practical consequences of an objective application of Mastrobuono are fairly positive and not at all earth-shattering. First, an objective application is a very fair approach to interpreting ambiguous arbitration provisions. It protects clients who have less contractual and legal resources from unfair surprise stemming from confusing and misleading arbitration clauses. For example, parties not heavily involved in the securities game or trained in law, like the Mastrobuonos, are not likely to know that New York law prohibits arbitral punitive damage awards. Applying the Mastrobuono analysis to parties in such circumstances will protect them from unknowingly contracting away their rights under arbitration.

Second, and more importantly, the objective application of Mastrobuono should have the effect of promoting contractual certainty between parties. Parties will be forced to expressly include the desired effects of the arbitration provision within their agreements. As a result, contract provisions dealing with arbitral powers will be drawn with more clarity and certainty. This benefits the contracting process by promoting up front and "above-the-table" dealing between two parties of unequal bargaining power like the Mastrobuonos and Shearson Lehman. Parties entering into a contract with an arbitration provision

contrast to Mastrobuono, where parties were represented by counsel and elected to arbitrate their dispute in New York before the AAA under the AMEX rules, such parties "cannot be surprised . . . that they are not entitled to punitive damages in arbitration as they chose to arbitrate in a state whose public policy prohibits their award".

Other commentators have expressed this same sentiment. See, e.g., Henry G. Appel, Recent Development, 12 OHIO ST. J. ON DISP. RESOL. 233, 240 (1996) (stating that "[s]ophisticated parties can continue to incorporate unfavorable arbitration law into a contract through a choice-of-law clause"); Blum, supra note 21, at 1073 (noting that "brokerage firms . . . [should] consider rewording their customer agreements in order to clearly state the unavailability of punitive damages"); Resnick, supra note 1, at 973 (commenting that "brokerage firms will change their agreements to explicitly limit punitive damages").

But see Douglas R. Davis, Comment, Overextension of Arbitral Authority: Punitive Damages and Issues of Arbitrability, 65 WASH. L. REV. 695, 712 (1990) (focusing his analysis on the supposed effects of the Raytheon decision). Mr. Davis believed that allowing for arbitral punitive damages would work to reduce the overall economic efficiency of the arbitration process. His argument might also be made applicable to Mastrobuono. In essence, his theory is that a court's decision to allow for arbitral punitive damages exposes parties bound by broad commercial arbitration agreements to excessive arbitral powers. Id. at 711-12. In order to maintain judicial protection from an "over-extension" of arbitral power, parties would be forced to draft narrow arbitration agreements. Id. at 712. As parties increase the time necessary to negotiate over the specific scope of their arbitration agreement, the economic efficiency of the process declines. Id.

While Davis presents a valid argument, it would seem that an objective application of Mastrobuono will promote the economic efficiency of the arbitration process. Parties that
will know exactly what rights they will receive or what rights they have waived under that provision. However, this aspect of the majority decision in Mastrobuono will probably not apply to the securities industry. Since September 7, 1989, the NASD has provided that "[n]o agreement shall include any condition which . . . limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award."295

V. CONCLUSION

The Supreme Court’s decision in Mastrobuono falls somewhere between Moses and Volt in the FAA’s judicial federal policy continuum. Although the decision in Mastrobuono was not a complete return to the substantive policies of Moses, the Court was able to reduce some of the harsher aspects of Volt by prohibiting the simple inclusion of a choice-of-law provision from undermining the federal policy favoring arbitration. Further, circuit courts that have since addressed arbitration agreements similar to the one in Mastrobuono have objectively applied the Mastrobuono Court’s interpretation and reasoning, holding in essence that Mastrobuono stands for the proposition that arbitrators presumptively maintain the power to award punitive damages unless the parties’ agreement states otherwise.

While the objective application of Mastrobuono has the theoretical effect of undermining the FAA federal policy of allowing parties’ intentions to control, there are some positive practical consequences. The objective application of Mastrobuono in such cases protects parties of unequal bargaining power from unfairly and unknowingly contracting away their arbitral rights. Additionally, it will promote contractual certainty by requiring parties to clearly articulate their intentions in contract provisions.

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spend the time and money up-front to negotiate what arbitral powers to include in their agreement will save more time and money in the long run by avoiding needless litigation over contract interpretation.

295 NASD, RULES OF FAIR PRACTICE 21(f)(4) (1995). The Mastrobuono Court did not consider this rule in its determination because the Mastrobuonos’ contract was signed before the rule was instituted. Mastrobuono, 115 S. Ct. at 1218 n.6. Also, in 1989, the rules of the NYSE and AMEX were revised in a similar fashion. See Virginia Trainor, Note, Mastrobuono v. Shearson Lehman Hutton, Inc., 56 L.A. L. REV. 1015, 1028 (1996).