

## Are There Due Process Limits on Arbitral Punitive Damage Awards?

EDWARD WOOD DUNHAM

Many franchisors heartily dislike arbitration. It is easy to understand why. To anyone who has ever endured a protracted arbitration, conducted without regard to evidentiary rules or governing law, only to receive a mystifying (or infuriating) award that a reviewing court will simply rubber stamp, the flaws of the process are manifest.<sup>1</sup> Certain franchisors tolerate those flaws because, even if they sometimes lose arbitrations, they appraise the aggregate risks of arbitration as materially lower than those of litigation, especially jury trials.<sup>2</sup> But what if a particular arbitrator or arbitration panel, offended by a franchisor's conduct, decides to impose substantial punitive damages? Do the constitutional guideposts that the U.S. Supreme Court erected in *BMW v. Gore*,<sup>3</sup> and recently reinforced in *State Farm Mutual Automobile Insurance Co. v. Campbell*,<sup>4</sup> apply to arbitration awards, and require judicial review far more stringent than the norm for arbitration? If not, a single punitive damage award could confound a franchisor's risk management calculus, and, if large enough, threaten the viability of a franchise system.

The U.S. Court of Appeals for the Eleventh Circuit<sup>5</sup> and at least two federal district courts<sup>6</sup> have held that arbitrations do not implicate the Constitution, and that even judicial enforcement of an arbitration award is not state action governed by the Due Process Clause of the Fourteenth Amendment. These courts overlooked much relevant state action precedent, however, and their opinions may reflect judicial enthusiasm for arbitration more than sound constitutional reasoning. Judges are understandably reluctant to "constitutionalize"<sup>7</sup> review of arbitration awards, for fear that this would jeopardize the ostensible simplicity and efficiency of arbitration. Yet the overwhelming majority of arbitration awards will never raise any colorable constitutional questions, and courts would have no difficulty promptly dispatching groundless constitutional claims. If, on the other hand, arbitrators are free to issue large punitive damage awards without any prospect of meaningful judicial review, for many businesses, including franchisors, that could prove a powerful disincentive to arbitration and undermine its vital role as a dispute resolution alternative.

Some may think that I am waxing hyperbolic about a pure-

ly theoretical issue because franchise agreements now routinely include punitive damage disclaimers. For several reasons, that fact should not allay concern about this decidedly real world dilemma. First, arbitrators determine the enforceability of those disclaimers, and their decisions on such matters of contract interpretation will almost always be confirmed. In some cases, moreover, arbitrators can rely on a franchise statute's antiwaiver provision in refusing to enforce the punitive damage disclaimer. Second, many franchise agreements (perhaps many thousands) are still in use that do not purport to exclude punitive damages. Third, the U.S. Supreme Court has just held, in *Green Tree Financial Corp. v. Bazzle*,<sup>8</sup> that if an arbitration clause does not expressly preclude class treatment, the propriety of class arbitration is for the arbitrator(s) to decide. Once again, many earlier generation franchise agreements say nothing about class or consolidated proceedings. Suppose an arbitration panel allows a class arbitration, refuses to enforce the franchise agreement's punitive damage disclaimer, if any, and concludes that the franchisor deserves severe punishment for reprehensible behavior. If *Gore* and *State Farm* do not limit the arbitrators' power, that hypothetical (unfortunately not far-fetched) would satisfy every franchisor's definition of a major league problem.

### The Argument Against State Action

The Eleventh Circuit's 1995 opinion in *Davis v. Prudential Securities, Inc.*<sup>9</sup> is the leading decision rejecting a constitutional challenge to an arbitral punitive damage award. An American Arbitration Association panel had awarded the claimant investor compensatory damages of \$483,684 and punitive damages of \$300,000 against Prudential Securities, and the district court confirmed the award.<sup>10</sup> On appeal, Prudential asserted among other things that the punitive damages were unconstitutional "because arbitration lacks the procedural protections and meaningful judicial review required for the imposition of punitive damages."<sup>11</sup> Writing for a unanimous panel, Judge Dubina rejected that argument out of hand, because "the arbitration was a private proceeding arranged by a voluntary contractual agreement of the parties,"<sup>12</sup> and the "state action element of a due process claim" was therefore missing.<sup>13</sup>

Prudential also contended that the district court's confirmation of the arbitration award was unconstitutional.<sup>14</sup> It is impossible to tell from the Eleventh Circuit's opinion how thoroughly Prudential briefed this argument. Judge Dubina merely said that Prudential was "apparently relying on [a]

*Edward Wood Dunham is the Editor-in-Chief of the Franchise Law Journal. This column, which expresses his personal opinions, does not reflect the viewpoint of the ABA Forum on Franchising or the Franchise Law Journal. Mr. Dunham gratefully acknowledges the able assistance of Wiggin & Dana associates Daniel Kalish and Sandra S. Glover in the preparation of this column.*

*Shelley v. Kraemer* theory that a court's enforcement of a private contract constitutes state action,"<sup>15</sup> and then pronounced that *Shelley's* "holding has not been extended beyond the context of race discrimination"<sup>16</sup> and that "[i]nstead, the concept of state action has been narrowed by the Supreme Court."<sup>17</sup>

For two reasons, *Davis's* significance may arguably be limited. First, the Eleventh Circuit decided the case a year before the U.S. Supreme Court decided *Gore*, so *Davis* did not address whether *Gore's* three-part due process test governs arbitral punitive damage awards.<sup>18</sup> Second, the *Davis* punitive damages were lower than the compensatories, and while the punitive/compensatory ratio is just one of the three *Gore* factors, the *Davis* award might well have passed constitutional muster in any event. Nevertheless, the Eleventh Circuit ruled unequivocally that judicial confirmation of an arbitration award is not state action requiring compliance with the Due Process Clause. If that holding is correct, arbitrators operating under the traditional, deferential standard of judicial review may have unbounded license to award punitive damages whenever—and in whatever amounts—they see fit.<sup>19</sup> I am no constitutional scholar, but the *Davis* panel, like other courts with a similar analysis, seems to have reached an untenable conclusion with extremely worrisome potential ramifications.<sup>20</sup>

#### **U.S. Supreme Court Precedent**

The U.S. Supreme Court has long-since established that when a court enters a judgment, thereby arming the plaintiff with the coercive power of the state, that is state action subject to the Due Process Clause. In *Shelley v. Kraemer*,<sup>21</sup> which involved state court enforcement of racial covenants, the Court held that although private agreements that discriminate do not involve the state, judicial enforcement of a purely private agreement to engage in racial discrimination constitutes state action.<sup>22</sup> Writing for a unanimous court, Justice Vinson reasoned that it "is clear that but for the active intervention of the state courts, supported by the full panoply of state power, petitioners would have been free to occupy the properties in question without restraint."<sup>23</sup> The Court determined that the participation of the state judiciary in the enforcement of the private contract was state action, and that the state court deprived the property owners of their Fourteenth Amendment rights.

The Supreme Court has extended the basic *Shelley* principle in a series of cases that involved private parties asking judges to exercise their statutory or common law powers.<sup>24</sup> In *New York Times v. Sullivan*,<sup>25</sup> for example, the Court held that judicial enforcement of a defamation cause of action was state action that implicated the Constitution. The *Sullivan* dispute was between private parties, but the Court held that a trial court could not, through a judgment, restrict a litigant's constitutional freedoms. As Justice Brennan explained, "the test is not the form in which state power has been applied but, whatever the form, whether such power has in fact been exercised."<sup>26</sup> Similarly, in *Cohen v. Cowles Media Co.*,<sup>27</sup> the Court recognized that the enforcement of a state contract

principle, promissory estoppel, was state action sufficient to implicate the Constitution. Justice White wrote for the majority that, because the "legal obligations" required by this doctrine "would be enforced through the official power of the Minnesota courts," any judgment applying promissory estoppel would suffice to establish state action.<sup>28</sup>

The Supreme Court has also held that property deprivations involve state action even when the state's only role is the ministerial act of a court clerk issuing a summons in the underlying contract action,<sup>29</sup> or issuing a writ of replevin executed by a state agent upon ex parte application of a private party.<sup>30</sup> Similarly, a state court's ministerial issuance of an order of sequestration based solely on a seller's allegations is state action.<sup>31</sup> As the Court observed in *Lugar v. Edmondson Oil Co.*,<sup>32</sup> although the decisions addressing the last three circumstances did not discuss state action, all "involved a finding of state action as an implicit predicate of the application of due process standards."<sup>33</sup>

At issue in *Lugar* was a state procedure allowing a creditor to obtain a prejudgment attachment against a debtor's property based solely on an ex parte allegation. The debtor argued that the state deprived him of his due process rights when a court clerk issued the writ of attachment, which the county sheriff then executed. The Supreme Court agreed, holding that a finding of state action did not require anything "more than invoking the aid of state officials to take advantage of state-created attachment procedures."<sup>34</sup> Also illustrative of the level of state judicial involvement sufficient to establish state action is *Tulsa Professional Collection Services v. Pope*,<sup>35</sup> where the Court distinguished between statutes of limitations and the Oklahoma state notice provisions that provided for extinguishment of all claims not filed within a specified period of time after notice was given. The former were not state action because they were "self-executing"—they did not require any further conduct by the courts.<sup>36</sup> The state notice provisions, however, were state action because they required participation by a court, as the notice requirements only became operative after probate proceedings commenced and the court had appointed an executor or executrix.<sup>37</sup>

This distinction between self-executing private conduct and private conduct assisted by the courts explains those instances when the Supreme Court has concluded that state action was not present, despite some involvement by the state. Statutes of limitations, although enacted by the state, are insufficient to establish state action because they extinguish property rights without further involvement by state officers, while notice limitations having the same effect but requiring involvement of a state judicial officer are enough to require compliance with the Due Process Clause. Similarly, state statutes that authorize private property deprivations through self-help are not state action, while those property deprivations discussed above, which involved state assistance, are state action.<sup>38</sup>

Consistent with this precedent, the Supreme Court has also held that when private parties exercise preemptory juror challenges in civil litigation, that is state action. In *Edmonson*

*v. Leesville Concrete Co.*,<sup>39</sup> the Court first noted that “although private use of state-sanctioned private remedies or procedures does not rise, by itself, to the level of state action, our cases have found state action when private parties make extensive use of state procedures with the ‘overt, significant assistance of state officials.’”<sup>40</sup> As Justice Kennedy concluded for the *Edmonson* majority, simply “enforcing a [racially-based] peremptory challenge” is state action because the trial court has “‘elected to place its power, property and prestige behind the [alleged] discrimination.’”<sup>41</sup>

From *Shelley* through *Edmonson*, the constitutional line is clear: state judicial enforcement of either conduct or a contract, even if limited to the purely ministerial issuance of writs and orders, is enough involvement of the state to require compliance with the U.S. Constitution. Judicial confirmation of an arbitration award should be no exception to that rule. Arbitration awards are not self-executing. In order to recover their punitive damages, successful arbitration claimants need the state’s coercive power, exercised by a court in the form of a judgment.

In fact, a state court judgment is the same state action present in *Gore*, *State Farm*, and *TXO Production Corp. v. Alliance Resources Corp.*<sup>42</sup> In each case, the U.S. Supreme Court considered whether a punitive damage award violated the Due Process Clause because the respective state court, by entering the award as a judgment, was engaging in state action. That a judgment would enforce an arbitration award, whereas those in *Gore*, *State Farm*, and *TXO* enforced jury verdicts, is a distinction without a difference: jury verdicts and arbitration awards alike are unenforceable unless and until a judge, exercising the state’s power, enters a judgment. And no state court, regardless of the underlying source of the judgment, can deprive defendants of their constitutional safeguards against excessive punitive damages.<sup>43</sup>

Furthermore, a judgment enforcing arbitral punitive damages involves the state significantly more than would a judgment confirming an arbitration award that merely compensates a plaintiff. Unlike, for example, contract remedies, which attempt to make the parties whole and are only for the benefit of those involved in the case, punitive damages—at least when based on a state statute—are for the public’s benefit, as they punish bad acts and seek to encourage appropriate future behavior. As Justice Stevens explained in *Gore*, a punitive damage award does not merely concern private rights, but affects the public by discouraging future conduct via a normative decision that the defendant must be punished.<sup>44</sup> Accordingly, even more than judicial enforcement of purely private rights, entering a punitive damage judgment surely constitutes “state action,” precisely as the Supreme Court recognized in *Gore* and *State Farm*.<sup>45</sup>

It is, of course, a truism that the public policy favoring arbitration is strong, but that policy is not all-powerful. If *Gore* and *State Farm* can never apply to any arbitral award of punitive damages, no matter how large, wildly disproportionate to compensatory damages, and badly out of whack with statutory penalties the punitive damages might be, that would allow arbitrators to run amok, issuing crippling punitive

damage awards with impunity. At first blush, reflexive judicial confirmation of such awards may seem necessary to preserve the benefits of arbitration. In reality, that short-sighted course will only serve to erode confidence in arbitration and, over time, dramatically reduce its use.

## Endnotes

1. For an inventory of arbitration’s drawbacks for franchisors, see Edward Wood Dunham, *Flattery Will Get You Nowhere*, 20 FRANCHISE L.J. 103, 104–05 (2001).

2. Edward Wood Dunham, et al., *Franchisor Attempts to Control the Dispute Resolution Forum: Why the Federal Arbitration Act Trumps the New Jersey Supreme Court’s Decision in Kubis*, 29 RUTGERS L.J. 237, 270 (1998). Based upon a study that I supervised, the conclusion that arbitrators are less likely than juries to produce system-threatening results has at least some modest empirical support. See Edward Wood Dunham, *Some Thoughts on Settling Franchise Disputes*, 22 FRANCHISE L.J. 147, 148 (2003).

3. 517 U.S. 559 (1996).

4. 123 S. Ct. 1513 (2003). My last column discussed the application of *Gore* and *State Farm* to franchise disputes. See Edward Wood Dunham, *Applying Constitutional Limits on Punitive Damages to Franchise Disputes*, 22 FRANCHISE L.J. 203 (2003).

5. *Davis v. Prudential Sec., Inc.*, 59 F.3d 1186 (11th Cir. 1995).

6. *E.g.*, *Morgan Keegan & Co. v. Lalande*, No. CIV. A. 00-2520, 2001 WL 43600 (E.D. La. Jan. 16, 2001); *Mantle v. Upper Deck Co.*, 956 F. Supp. 719, 723–35 (N.D. Tex. 1997).

7. *Davis*, 59 F.3d at 1193.

8. No. 02-634, 2003 U.S. LEXIS 4798 (U.S. June 23, 2003).

9. *Davis*, 59 F.3d at 1186.

10. *Id.* at 1187, 1188.

11. *Id.* at 1190.

12. *Id.* at 1191.

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. For a discussion of the *Gore* test, see Dunham, *Some Thoughts on Settling Franchise Disputes*, *supra* note 2.

19. A recent illustration of a runaway arbitral punitive damage award is *Medval USA Health Programs v. Memberworks, Inc.*, CV020821887S, 2003 Conn. Super. LEXIS 1633 (May 22, 2003). There, an arbitration panel awarded the claimant \$5 million in punitive damages in a contract dispute, even though the panel did not award the claimant any compensatory damages. The respondent Memberworks filed a motion with the Connecticut Superior Court to vacate the award as unconstitutional, but the trial court denied the motion. In his decision, which is now on appeal, the trial judge concluded that because the arbitrators were not state actors, the court could not review the punitive damage award for excessiveness under *Gore*. Although not involved in the underlying arbitration, Mr. Dunham’s firm represented Memberworks in the subsequent state court proceedings to vacate the arbitration award.

20. As Judge Kaplan wrote in *Commonwealth Assocs. v. Lestos*, 40 F. Supp. 2d 170, 177 n.37 (S.D.N.Y. 1999) (citations omitted):

The Court respectfully doubts that the rationale for this result set forth in *Davis v. Prudential Sec., Inc.* . . . that an arbitration award involves no state action—is well founded. While the procedures utilized in private arbitration do not constitute state action, the application of the coercive power of a court to confirm and enforce an arbitration is arguably another matter.

21. 334 U.S. 1 (1948).

22. *Id.* at 18.

23. *Id.* at 19.

24. In *Davis*, the Eleventh Circuit asserted that “the holding of *Shelley* . . . has not been extended beyond the context of race discrimination.” *Davis v. Prudential Sec., Inc.*, 59 F.3d 1186, 1191 (11th Cir. 1995). As the ensuing discussion in the text demonstrates, however, *Davis* ignored most of the relevant U.S. Supreme Court precedent, and expressed an unduly crabbed view of state action.

25. 376 U.S. 254 (1964).

26. *Id.* at 265.

27. 501 U.S. 663 (1991).

28. *Id.* at 668.

29. *Sniadach v. Family Fin. Corp.*, 395 U.S. 337 (1969).

30. *Fuentes v. Shevin*, 407 U.S. 67 (1972).

31. *Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974).

32. 457 U.S. 922 (1982).

33. *Id.* at 927.

34. *Id.* at 942.

35. 485 U.S. 478 (1988).

36. *Id.* at 483.

37. *Id.* at 484.

38. *See* *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149 (1978) (holding that warehouse company’s sale of customer’s goods for nonpayment of storage charges did not constitute state action, even though authorized by statute, as this was a self-help remedy that did not require the state’s participation); *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972) (refusing to find state action by private club that had a state-regulated liquor license, noting that the state “plays absolutely no part in establishing or enforcing the membership or guest policies of the club that it licenses to serve liquor”).

39. 500 U.S. 614 (1991).

40. *Id.* at 622, quoting *Tulsa*, 485 U.S. at 485 (emphasis added).

41. *Id.* at 624 (quotation and citation omitted).

42. 509 U.S. 443 (1993).

43. *BMW v. Gore*, 517 U.S. 559, 575 (1996); *TXO*, 509 U.S. at 453–54.

44. “Punitive damages may properly be imposed to further a State’s legitimate interests in punishing unlawful conduct and deterring its repetition.” *Gore*, 517 U.S. at 569.

45. At least two state courts have recently applied *Gore* to arbitral punitive damage awards, without deciding whether judicial confirmation of the award would constitute state action. In *Sawtelle v. Waddell & Reed, Inc.*, 754 N.Y.S.2d 264 (N.Y. App. Div. 2003), a unanimous three-judge panel of the New York Appellate Division vacated an arbitration award of punitive damages because they were grossly excessive under *Gore*. The *Sawtelle* court emphatically rejected the plaintiffs’ argument that absent state action, *Gore* could not apply. The court concluded that state action was “besides the point since *Gore* is not only applicable to [a] due process analysis of a punitive damage award but also provides a guide for determining whether such an award is irrational.” *Id.* “The principle that punishment should fit the crime ‘is deeply rooted and frequently repeated in common law jurisprudence’” (quoting *Gore*, 517 U.S. at 575 n.24), the court stressed, and “[i]n agreeing to arbitration, [the claimant] did not waive its right to the protection of any constitutional and statutory constraints on the award of punitive damages.” *Id.* at 284. *See* *Hadelman v. DeLuca*, CV970060279S, 2003 Conn. Super. LEXIS 1748 (June 12, 2003). Mr. Dunham represents the defendants in *Hadelman*, which is now on appeal.