The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

March 1995 Volume 2 Number 1

In This Issue...

The PIABA Quarterly

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Editor's Note

The feature article in this issue is a memorandum on the Florida Economic Loss Rule which was contributed by Neal Blaher. We thank Neal for his efforts.

The Bulletin Board appears for the first time in our publication. If you have information or documents that might be responsive to any requests made on the Bulletin Board, please make the effort to contact the member making the request.

A complimentary copy of this issue of the *Quarterly* is being mailed to about 100 expert witnesses who have expressed an interest in receiving a copy. Starting with the April issue we will offer the newsletter to these experts for a nominal subscription rate.

The deadline for receiving submissions for the April issue of the *Quarterly* is April 5th. All submissions, large or small, should be accompanied by a computer disk of the submitted material.

Letter From the President

Seth Lipner, DEUTSCH & LIPNER, Garden City, New York

As we begin the New Year, the glow from our annual meeting at the Breakers has not worn off. On behalf of myself and my fellow Directors, I want to thank you for your attendance and enthusiastic participation. It is especially satisfying to see PIABA grow as an organization; the unselfish sharing of ideas that takes place among our members is, in my view, unparalleled.

The last quarter of 1994 has been an eventful one for PIABA, and I have several things to report. First, PIABA submitted an Amicus Curiae Brief to the United States Supreme Court in Mastrobuono v. Shearson Lehman. Oral argument is scheduled for January 10th. We are optimistic about the case, especially in view of the fact that the SEC also appeared as Amicus on behalf of the Mastrobuonos. Our brief, written by Stuart C. Goldberg, Mark E. Maddox and myself, highlighted the fundamental inconsistency between the policies of the Federal Arbitration Act and New York's Garrity rule. Specifically, we argued that the New York Choice of Law provision was unconscionable in light of the adhesive nature of the Customer Agreement, and the way in which the New York Choice of Law provision violates NASD rules and state consumer-protection anti-waiver rules. We also highlighted the need for punitive damages as a remedy available in securities arbitration.

The second significant event was that, on November 21st, several PIABA directors and members participated in a symposium

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at the New York Stock Exchange on arbitration. The symposium was well attended by industry representatives, government regulators and officials from the Exchange and the NASD. Professor Constantine Katsoris served as the moderator. The discussion ranged from Customer Agreements, to eligibility, to discovery in arbitration, to punitive damages. The discussion was interesting, lively and frank, and there were several pointed exchanges. It is unclear what will come of these discussions, but it gives a chance to air our grievances about arbitration, and demonstrate the worthiness of our case to interested parties. Thanks to Professor Katsoris, the transcript of the proceeding will appear next month in the Fordham Law Review.

Third, PIABA has been invited to make a presentation to the Ruder Commission on January 16, 1995 in New York. Rosemary Shockman, Mark Maddox and myself will appear on behalf of PIABA. We hope to be able, at that meeting, to present PIABA's recommendations for improving document discovery in arbitration. A sub-committee chaired by Rosemary Shockman (Bob Uhl, Al Aidikoff, Joel Goodman and Dave Robbins are the other members), have been studying this issue, and will be making specific recommendations.

We wish to offer congratulations to Tom Grady upon his appointment to the vacant public seat on SICA. We are confident that with Tom joining Jim Beckley et al. at that organization, investors will continue to have a strong voice at SICA.

Finally, we have given some thought to the venue for next year's annual meeting and have basically decided on the San Diego area. We are exploring resorts and hotels in that area and hope to have a decision and more information for you in the spring newsletter.

On a final note, I greatly appreciate the correspondence and calls I receive as President of PIABA. While I try to address each item brought to my attention, in instances where you are looking for information, I strongly suggest dropping a note to Jerry Stanley for inclusion in the bulletin board section of the newsletter. We all owe a debt of gratitude to Jerry for developing and working on the newsletter. Your contributions to the bulletin board section will make this newsletter more useful for each of us. On behalf of everyone at Deutsch & Lipner, and the Directors of PIABA, I wish you a happy and prosperous New Year.

The Economic Loss Rule Does Not Prevent Florida Claimants from Asserting Common Law Tort Claims, Including Punitive Damages, For Fraudulent and/or Negligent Conduct and Breach of Fiduciary Duty Separate and Apart from any Breach of Contract

Brief Contributed by Neal J. Blaher, Esquire
Law Office Of Neal J. Blaher, Orlando, Florida

The so-called "economic loss rule" had its genesis in Florida in AFM Corp. v. Southern Bell Telephone & Telegraph Co., 515 So. 2d 180 (Fla. 1987) and Florida Power & Light Co. v. Westinghouse Electric Corp., 510 So. 2d 899 (Fla. 1987). Those decisions held that a party to a contract who suffers purely economic losses without personal injury or property damage may recover in contract and not in tort. However, the court made it clear that this rule did not change prior law in Florida. Florida Power, 510 So.2d at 902. As the court recognized in AFM, prior law includes the independent tort doctrine. 515 So.2d at 181. That doctrine permits actions sounding in tort, notwithstanding the existence of a contractual relationship between the parties, where the tortious conduct on

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which plaintiff's claims are based is separate and distinct from the contract. Gregg v. U.S. Industries, ..., 887 F.2d 1462, 1474 (11th Cir. 1989); Lewis v. Guthartz, 428 So.2d 222, 223 (Fla. 1982); Griffith v. Shamrock Village, Inc., 94 So.2d 854 (Fla. 1957).

That the economic loss rule did not eliminate the independent tort doctrine was made even clearer in First Interstate Development Corp. v. Ablanedo, 511 So. 2d 536 (Fla. 1987). There, the court held—in a case arising out of a contractual relationship—that the issue of punitive damages must be submitted to the jury once the plaintiff makes out a prima facie case of fraud.

> "The overwhelming weight of authority in this state makes it clear that proof of fraud sufficient to support compensatory damages necessarily is sufficient to create a jury question regarding punitive damages." Id. at 539 (footnote omitted).

Ablanedo was decided on the same day as Florida Power. However, the court did not suggest in Ablanedo that the existence of a contractual relationship foreclosed a claim for fraud or tortious breach of fiduciary duty independent of the contractual relationship. This conclusion does not make Ablanedo inconsistent with Florida Power or AFM, for in the latter two decisions, the plaintiff simply had not proven an independent tort.

There have been numerous cases decided in Florida after AFM and Florida Power in which courts have permitted tort claims despite the existence of a contractual relationship between the parties, including stockbroker fraud actions. In Azar v. Richardson Greenshields Securities, Inc., 528 So. 2d 1266 (Fla. 2d DCA 1988), decided on July 22, 1988, a customer of a brokerage firm filed a four-count complaint. The first count asserted violations of Chapter 517 Florida Statutes in connection with allegations of misrepresentations made by a broker to induce the customer to purchase a particular stock. Count II sought both compensatory and punitive damages for common law fraud and misrepresentation. The third court was voluntarily dismissed by the plaintiff, and the fourth count asserted a claim for breach of contract. Id. at 1267-68. The trial court directed a verdict against the plaintiff on the statutory securities and common law fraud counts, but the district court of appeal reversed. Id. at 1269-70. The court found that the jury should have been permitted to decide whether the plaintiff—a customer of a brokerage firm—had proven the elements of his statutory securities and common law fraud claims notwithstanding the contractual relationship between the customer and the firm. Id.

In Ruding and E.F. Hutton & Co., Inc. v. Thompson, 517 So. 2d 706 (Fla. 4th DCA December 9, 1987), the trial court sustained a verdict for fraudulent misrepresentation against E.F. Hutton and one of its stockbrokers, but granted a directed verdict against the plaintiff on punitive damages. The court reversed on the authority of Ablanedo and remanded the case for a new trial "on the punitive damage issue." Id. at 707.

See also Horizon Leasing v. Leefmans, 568 So.2d 73 (Fla. 4th DCA 1990) (punitive damages award affirmed in action for fraud and civil theft in context of a motor vehicle lease agreement); Miller v. Reinhart, 548 So. 2d 1174, 1175 (Fla. 4th DCA 1989)("Once a plaintiff establishes a claim for compensatory damages based on fraud, a jury question is automatically created regarding punitive damages."); Blue Cross/Blue Shield of Florida, Inc. v. Weiner, 543 So. 2d 794, 797-98 (Fla. 4th DCA 1989)(the trial court properly submitted the issue of punitive damages to the jury on plaintiffs' claims of fraud and emotional distress, despite the parties' ongoing contractual relationship); Rappaport v. Jimmy Bryan Toyota of Ft. Lauderdale, Inc., 522 So. 2d 1005, 1006 (Fla. 4th DCA 1988)("in all cases of fraud the jury is empowered to award punitive damages"); Boyd v. Oriole Homes Corp., 515 So. 2d 300, 301 (Fla. 4th DCA October 28, 1987)("Although this is partly an action for breach of contract, punitive damages are proper since appellee pled and proved the independent tort of fraud and the jury found appellee's actions constituted malice, moral turpitude, wantonness, willfulness or reckless indifference to the rights of others")(emphasis added, citations omitted).

Most of these decisions rely on Ablanedo, and all of them demonstrate that "the economic loss rule has not changed or modified any decisions of [the Florida Supreme] Court," including the independent tort doctrine. Florida Power, 510 So. 2d at 902; see AFM, 515 So. 2d at 181. These cases further demonstrate the continued viability of claims for breach of fiduciary duty, misrepresentation and negligence in stockbroker fraud litigation.

Ablanedo and the post-Florida Power/AFM decisions which allowed tort claims and recovery of punitive damages thereunder in stockbroker and other fraud cases (pursuant to the independent tort doctrine) are not in any way inconsistent with the economic loss rule set forth in Florida Power and AFM. Rather, they demonstrate the continued viability of tort claims for fraud, breach of fiduciary duty and negligence in securities cases. This is because the duties of a stockbroker which are breached in cases of negligence, fraud and breach of fiduciary duty extend beyond the four corners of the non-negotiated, preprinted form agreement placed in front of the customer for his signature.

In the context of a stockbroker fraud case such as the case at bar, courts have always permitted tort claims for negligence, fraud/misrepresentation and breach of fiduciary duty. See, e.g., Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042 (11th Cir. 1987); Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498 (11th Cir. 1985); Aldrich v. Thomson McKinnon Securities, Inc., 756 F.2d 243 (2d Cir. 1985); Silverberg v. PaineWebber, Jackson & Curtis, Inc., 710 F.2d 678 (11th Cir. 1983); Malandris v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 703 F.2d 2 (10th Cir. 1981); Petrites v. J.C. Bradford & Co., 648 F.2d 1033 (5th Cir. 1981); Miley v. Oppenheimer & Co., Inc., 637 F.2d 318 (5th Cir. 1981); Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978); In re Atlantic Financial Management, Inc., 603 F.Supp. 135 (D.Mass 1985); Morgan Olmstead, Kennedy & Gardner, Inc. v. Schipa, 585 F.Supp. 245 (S.D.N.Y. 1984); Starkenstein v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 572 F.Supp. 189 (M.D.Fla. 1983); Azar v. Richardson Greenshields Securities, Inc., 528 So.2d 1266 (Fla. 2d DCA 1988); Puchner v. Drexel Burnham Lambert, Inc., 498 So.2d 550 (Fla. 3d DCA 1986); Dean Witter Reynolds, Inc. v. Leslie, 410 So.2d 961 (Fla. 3d DCA 1982). The AFM and Florida Power decisions did not change this. See Newsom v. Dean Witter Reynolds, Inc., 558 So.2d 1076, 1077 (Fla. 1st DCA 1990).

In Dean Witter Reynolds, Inc. v. Leslie, 410 So.2d 961 (Fla. 3d DCA 1982), an award of punitive damages was upheld because the case between the customer and the brokerage firm sounded in tort, not contract.

> "The defendants next contend it was error to send the claim for punitive damages to the jury because, it is asserted, this is a breach of contract action for which, concededly, punitive damages are not ordinarily recoverable. ... The fatal flaw in this analysis, however, is that this is not in any sense a breach of contract action; it is a negligence and fraud action which was pled and tried below as such. It may not now, in our view, be recharacterized on appeal in an effort to avoid the punitive damages award." Id. at 964 (citation omitted).

Thus, it is clear that securities cases routinely include common law tort claims for negligence, fraud, and/or breach of fiduciary duty, whether or not a claim for breach of contract is asserted. Under the independent tort doctrine, plaintiffs in securities cases may seek punitive damages on such tort claims regardless of the existence of a contractual relationship between the parties. The economic loss rule has not changed this. Florida Power, 510 So.2d at 902; see AFM, 515 So.2d at 181.

The brokerage firms rely on a number of cases in support of their contention that the economic loss rule bars customers' common law tort claims. In Interstate Securities Corp. v. Hayes Corp., 920 F.2d 769 (11th Cir. 1991), the federal court of appeals followed AFM and Florida Power in barring a brokerage firm customer from recovering tort damages for negligence and breach of fiduciary duty because of the contractual relationship between the parties. However, the Hayes decision is distinguishable factually and, more importantly, is based on the federal court's serious misconceptions of Florida law. Turning first to the factual aspect, Hayes did not involve an individual customer relying on a broker to manage his account and provide investment advice in a fiduciary capacity; rather, the customer was a corporation which, through its president and sole shareholder, wished to trade options and commodities at the customer's direction. When the customer's bold trading led to sizable margin calls that could not be met, the brokerage firm liquidated the account and filed suit to recover the debit balance. The customer responded with counterclaims for breach of contract, breach of fiduciary duty, negligence and violation of

Regulation T (pertaining to margin requirements).

The court viewed the negligence claim (in the co· ·t of the factual setting before it) as "negligent breach of contract" and therefore indistinguishable from the breach of contract claim. The court therefore dismissed the negligence claim under the economic loss rule. 920 F.2d at 776.

With respect to the fiduciary duty claim, the court inexplicably found "no Florida state court cases that address the application of [the economic loss rule] to a claim for breach of fiduciary duty," despite the plethora of cases cited above. Id. at 777. The court did not address Ablanedo or any of the other cases discussed above, relying instead on a lower court decision dismissing a fraud claim under the economic loss rule in the context of a construction contract dispute. See J. Batten Corp. v. Oakridge Investments 85, Ltd., 546 So.2d 68 (Fla. 5th DCA 1989). In J. Batten, Batten was hired by Oakridge to construct a restaurant. When Oakridge failed to pay for the work, Batten filed suit for a mechanic's lien, breach of contract and fraud. The fraud count alleged that after refusing to pay for work done by Batten, Oakridge induced Batten to complete construction by fraudulently representing that it would pa; .he court affirmed the trial court's dismissal of the fraud count, citing AFM, but without any explanation.

Relying on J. Batten and believing that no other authority existed in Florida, the Hayes court concluded:

> "Consequently, we hold that if a fraud claim is foreclosed as a matter of Florida law under the AFM doctrine [economic loss rule], a claim for fiduciary duty must be prohibited as well." Id. at 778. Accord City of Miami Firefighters' & Police Officers' Retirement Trust v. Invesco Mim, Inc., 789 F.Supp. 392, 394 (S.D.Fla. 1992).

As Ablanedo and other cases demonstrate, fraud is by no means foreclosed under the economic loss rule, making the very foundation of the Hayes decision suspect. Furthermore, decisions handed down by the Eleventh Circuit both before and after Hayes reached a dil .nt conclusion. See, e.g., Palm Beach Atlantic College, Inc. v. First United Fund, Ltd., 928 F.2d 1538, 1547 (11th Cir. 1991)(punitive damage award upheld where fraud claim "arose from the same facts" as the breach of contract claim); Kee v. Nat'l Reserve Life Ins. Co., 918 F.2d 1538, 1543 (11th Cir. 1990)("the mere existence of a contract claim does not automatically vitiate all causes of action in tort. Tort claims can be appropriate under Florida law where there is some wrongful conduct resulting in the contractual breach")(citation omitted); Gregg v. U.S. Industries, Inc., 887 F.2d 1462, 1474 (11th Cir. 1989) ("Florida law does not require a plaintiff to prove that the conduct or acts giving rise to a tort claim are different from or additional to those acts that support the plaintiff's breach of contract claim. '[W]here the acts constituting a breach of contract also amount to a cause of action in tort there may be a recovery of exemplary damages upon proper allegations and proof.'")(quoting Griffith v. Shamrock Village, Inc., 94 So.2d 854, 858 (Fla. 1957)). Accord Floyd v. Video Barn, Inc., 538 So.2d 1322, 1324 (Fla. 1st DCA 1989)("Florida law is clear that when a breach of contract is attended by some additional conduct which amounts to an independent tort, such a breach can constitute negligence")(citing Griffith).

In Bankatlantic v. Blythe Eastman Paine Webber, Inc., 955 F.2d 1467 (11th Cir. 1992), the Eleventh Circuit clouded Florida law even further. There, Bankatlantic retained PaineWebber as a financial advisor to assist in blocking several hostile takeover attempts, and also used the firm in two interest rate swap transactions. A fall in interest rates resulted in losses on the interest rate swaps, thus prompting suit. Id. at 1469. In addressing the economic loss issue the court noted that its decision in Hayes found "no bar to tort claims for injury or loss 'outside the scope of the contract between the parties.'" Id. at 1475 (citation omitted). Bankatlantic's tort claims were properly allowed because the interest rate swaps were outside the scope of the financial advisory agreement. Id. Clearly, these decisions call into question the authority of Hayes.

Finally, Hayes should not apply because the present case involves not merely fraud in performing contractual and other duties, but also fraud in inducing the customer to enter into a contractual relationship with the broker. In particular, the broker induced the customer to open an account by representing that he would properly advise the customer and act in their best interests when in fact the broker intended to serve his own interest in commission income and meeting his firm's demands for a certain level of production.

The courts have made it clear that the economic loss rule does not apply to claims of fraudulent inducem Brass v. NCR Corp., 826 F.Supp. 1427, 1428 (S.D.Fla. 1993); Romero v. Prudential-Bache Securities, Inc., 5 Fla.L.WeeklyFed. D520, D523 (S.D.Fla. Aug. 23, 1991); Williams Elec. Co., Inc. v. Honeywell, Inc., 772 F.Supp. 1225, 1237-38 (N.D.Fla. 1991); Lou Brachodt Chevrolet, Inc. v. Savage, 570 So.2d 306, 308 (Fla. 4th DCA 1990); Burton v. Linotype Co., 556 So.2d 1126, 1128 (Fla. 3d DCA 1989).

In Burton, Plaintiffs sued for fraud, deceit, negligent misrepresentation and false advertising as inducements for entering into a contract to lease a Linotype Graphic System ST. The complaint also alleged breach of warranties under the contract. The court held the tort claims to be independent of the breach of warranty claims.

> "...MLG and Burton urge that negligent misrepresentation, fraud and misleading advertising are torts independent of their breach of warranty claims. We agree. Fraud in the inducement and deceit are independent torts for which compensatory and punitive damages may be recovered. Because the claim based on misleading advertising requires the same proof as the fraud claim, it is also an independent tort claim." 556 So.2d at 1126 (citations omitted).

A comparison of the overwhelming authority permitting common law tort claims in securities cases and the few puzzling cases relied upon by the brokerage firms demonstrates the lack of support for a dismissal of any and all common law tort claims which a customer may bring against a broker and his or her brokerage firm in Florida for securities law violations.

Minnesota Appeal Court Rules on Punitive Damages

Director Bill Lapp reports that the Minnesota Appeals Court bought the argument that has been espoused by low PIABA Director Bob Dyer — that the execution of the Uniform Submission Agreement is a contract which binds the parties and empowers the arbitrators to rule on those issues raised in the Statement of Claim. The case is Kennedy Matthews, Landis Healy & Pecora, Inc. v. Young. (The investor was represented by PIABA member and former Director Mark Briol.)

The brokerage firm appealed the district court's confirmation of an arbitration panel's award of punitive damages on the grounds that the panel had exceeded its powers. The Court found that the parties had submitted the claim to arbitration based on the recitals in the submission agreement and the allegations made in the Statement of Claim. Since the claim included a demand for punitive damages, the Court concluded that the parties had agreed to allow the arbitrators to decide on that issue and be bound by the result.

U.S. District Court In Texas Considers Customer Agreement vs. Submission Agreement Issue

Another case involving punitive damages is reported by Bob Dyer. The case is Bear, Stearns & Co. v. Tottenham Corporation. (U.S. District Court, Northern District of Texas). Bear Stearns sought to vacate an award of punitive damages based on the New York choice of law provision in the customer agreement. However, the Court, citing Piggly Wiggly v. Piggly Wiggly Truck Driver's Union, 611 F.2d 580 (5th Cir. 1980); pointed out that the law in the Fifth Circuit is that once the parties actually submit a dispute to arbitration, a court must look both to the agreement to arbitrate and the submission agreement to determine the authority of the arbitrators.

The Tottenham Court then went on to discuss the types of choice of law clauses in arbitration agreements — from the very narrow "this Agreement shall be construed under the laws of the State of New York" to the very broad language of "this Agreement... shall be construed, and the rights and liabilities of the parties determined under the laws of the State of New York".

The Court found that the agreement signed by Tottenham fell somewhere in between the narrow and broad arbitration agreements. Therefore, because the agreement was in the grey area, the Court found that it was up to the Panel to construe the scope of the choice of law provision. Since this matter was considered by the Court on appeal of the award, the Court

chose not to disturb the award since the arbitration clause was potentially subject to the interpretation arved at by the arbitration panel.

U.S. Supreme Court Decision Again Favors Arbitration

The U.S. Supreme Court affirmed its stance favoring enforcement of agreements to arbitration. The Court in Allied-Bruce Terminex Cos. v. Dobson, ruled that agreements to arbitrate apply broadly to all contacts involving interstate commerce, even if the consumer didn't contemplate that the activity involved interstate commerce. Justice Stephen Breyer, in his first majority opinion for the court, wrote the decision which overturned an Alabama State Supreme Court decision which had allowed a group of several consumers to sue in state court.

Proposed SEC Rules Changes

The SEC has proposed amendments to its rules regarding limited partnership roll-up transactions, in order to implement provision of the Limited Partnership Roll-up Reform Act of 1993 which added new section 14(h) to the Securities Exchange Act of 1934. The proposal would amend the current definition of a roll-up transaction to any transaction involving the combination or reorganization of one or more limited partnerships, directly or indirectly, in which some or all of the investors receive new securities in another entity.

Another proposal by the SEC would require disclosure with respect to security ratings in prospectuses under the Securities Act of 1933 and material changes in security ratings on From 8-K under the Securities Act of 1934. This would require disclosure if a debt security is not rated by a nationally recognized statistical rating organization (NRSRO).

News From New York Litigation

Director Seth Lipner files this report on the ongoing New York procedural infighting. The Luckie and Manhard cases were argued in the New York Court of Appeals on January 4, 1995 (the issue is whether, under New York law, the statute of limitations (as distinguished from eligibility) is a question for the arbitrators or the Court).

We are still awaiting a decision from the Appellate Division (the intermediate level appellate court) in Merrill Lynch v. McLoud. That case is the first to present the "clean" jurisdictional issue, i.e. whether New York obtains jurisdiction over an arbitration before the NASD or the NYSE in cases where the customer has no other contacts with New York.

As you may have sensed (because you stopped receiving papers from Larry Fenster), this last quarter of 1994 has seen a curtailment of Court actions to stay arbitration in New York because Judge Solomon has ceased to sign any more such orders in cases in which the investor had no contact with New York. Cases continue to pop up, however, where the investor has arguably had contact with New York. For instance, last month Judge Solomon ruled that the fact that an LP was formed under New York law (and owned New York realty) did not, by itself, give New York jurisdiction over a nonresident who was seeking to arbitrate against the brokerage firm that sold the partnership.

We expect, however, that the litigation pit stop will continue to see action, however. The scene will simply shift to the investor's state of residence, at least in places that follow Sorrells, etc.

PIABA Participates as Amicus at Oral Argument Before the Fifth Circuit

On November 3, 1994, the U.S. Fifth Circuit Court of Appeals heard oral argument on another issue at the heart of many arbitration battles — whether the NASD and NYSE six year eligibility rules are to be determined by the court or by the arbitration panel. This appeal involves two cases which came to the 5th Circuit from Texas Smith Barney v. Boone (Tracy Pride Stoneman for the investor) and Smith Barney v. Sherman (Ron Schy for Mr. Sherman). PIABA filed an Amicus brief (Michael Gilmore and John Lawlor authored the brief).

Tracy Stoneman argued that the six year eligibility rule is indeed procedural (as opposed to substantive rules, as the brokerage firms argue) as evidenced by their

enclosure in the "Code of Arbitration Procedure". Therefore, she argued, as with any procedural determination, t' decision is for the arbitrators.

Director Jerry Stanley appeared at oral argument for PIABA. The court seemed at once both receptive to and curious about PIABA's interest in the case since the investors were Appellees, having won in the lower court. Jerry argued that the origin of the six year rule was procedural — quoting a Brooklyn Law Review article (supplied by PIABA Director Jim Beckley). In the Brooklyn article, Professor Constantine Katsoris, one of the original members of SICA, wrote, "From the very beginning the Code provided that no dispute, claim or controversy would be eligible for submission to SRO arbitration if six years had elapsed since the occurrence or event giving rise to the act or dispute, claim or controversy. This rule was inserted as a matter of SRO convenience to weed out stale claims. It was never intended, however, to limit or eradicate claimants' rights. Unfortunately, some courts have interpreted this rule as substantive instead of merely procedural, thus denying claimant's relief after the six years elapsed." (emphasis added.) Constantine N. Katsoris, Should McMahon be Revisited?, 59 Brook. L. Rev. 1113, 1123 (1993).

Smith Barney's lawyer argued that the court should decide eligibility — but then went one step further. He argued that once the court has barred the investor from arbitration under the eligibility rules, the arbitration clause in the customer agreement then bars the investor from then going back and litigating in court. As Judge Wise pointed out at the oral argument, what Smith Barney was advocating was, in essence, to convert the six year eligibility rule to a six year statute of limitations.

Ron Schy espoused a persuasive counter argument — investors with pre-1987 (and thus pre-Shearson v. McMahon) customer agreements could not have intended that binding arbitration be their sole remedy since arbitration agreements pre 1987 were voluntary rather than binding.

Don't chuckle if you think that the result that Smith Barney proposed is absurd. At least one Federal Court in Texas has agreed with the premise that if there is a binding arbitration agreement but the claim is ineligible, the investor is left with no place to go. (See, Calabria v. Merrill Lynch, 855 F. Supp. 172 (N.D. Texas 1994).

The Fifth Circuit's decision on this case is due out in March/April.

Shearson Client/Margin Agreements

Director Diane Nygaard reports that the Kansas Securities Commissioner has found that the Client Agreement previously used by Shearson was deceptive in that it authorized a margin account unless the customer specifically and affirmatively struck out the authorization paragraph. The Commissioner requested that Shearson modify its agreement to require a customer's affirmative response with an additional signature be required in order to open a margin account with the firm.

[Editor's Note: How about all of the cash or asset management type accounts used by all the major firms. In all these accounts, the customer agreements automatically authorize the use of margin in the account.]

Prudential Expedited Arbitrations of Private Placement L.P.'S

For those of you grappling with upcoming expedited arbitrations with Prudential on private placement direct participation limited partnerships, Director Mark Maddox suggests you consult Appendix "F" of the NASD Rules of Fair Practice which outlines the special suitability standards and disclosure rules which must be followed in the sale of any direct participation private placement program.

Along those same lines, Director Jerry Stanley observes that many of the deep tax-shelter real estate private placements sold in the early 80's by Prudential used an accounting method known as the "Rule of 78" to generate the multiple tax write-offs. In many cases, these deductions were subsequently disallowed by the IRS. In many instances, the IRS not only threw out the deductions but also assessed penalties against the taxpayer/investor — meaning that, in the view of the IRS, there was no reasonable basis for the deductions in the first place. It seems a logical extension to argue that Prudential's failure to disclose the aggressive nature of the Rule of 78 in generating the tax write-offs was a misrepresentation in and of itself.

Prudential Expedited Arbitration Result

To keep your spirits up for your Prudential expedited arbitrations, here's a report on an arbitration award on Prutech R & D 1984. The investment was $40,000. Prudential declined to make an offer. The investor was the president of a building supply company, had a net worth of $1.5 million, and had purchased a VMS deep tax shelter real estate limited partnership just one month before the Prutech purchase. The investor had received $24,000 back in distributions and another $8,000 in tax benefits — meaning his out of pocket losses were $8,000. The arbitrator, a former SEC regional administrator, awarded the investor $20,000.

Taping Telephone Conversations

Mark Raymond, Tew & Garcia-Pedrosa, was prompted by our discussion at the Annual Meeting about taping telephone conversation. Mark points out that Florida Statutes, Chapter 934, specifically prohibits taping phone conversations without the prior consent of all parties to the communication. This is a third degree felony in Florida, punishable by up to five years and/or a $5,000 fine. Obviously, it is incumbent for all to check the applicable state statutes before engaging in these activities.

Update on PIABA Arbitrator Pool Expansion Project

We have received donations in the amount of $3,850 for the Arbitrator pool expansion project. Another $10,000 or so has been pledged. As was reported in our December 19th correspondence to you, our target is $20,000 to implement this program. We ask that all those who have pledged money to please send your donation to Boyd Page by February 15, 1995. We are anxious to get this project started.

The BULLETIN BOARD

Director Mark Maddox would like to announce that he has been appointed by President Seth Lipner to form a committee to examine the feasibility of establishing a computer bulletin board service where PIABA members could swap information including background information on prospective arbitration panel members and exchange relevant information and documents with other members.

Mark asks that any PIABA members interested in serving on this committee contact him before February 15th. Telephone (317) 574-2040.

* * *

Allan Fedor, Fedor & Fedor, has two requests of all PIABA members:

1) that each member write to William McLucas of the SEC, Joseph Hardiman of the NASD and your state securities regulator to make them aware of the brokerage firms' abuse of Section Six of the Code of Arbitration Procedure. As you know, Section Six prohibits the parties from subsequently going to court on issues which have been properly submitted to arbitration. Unfortunately, the NASD member firms routinely disregard the rule. More unfortunately, the NASD has totally disregarded these rules violations by its members. Allan has had some success in getting the ear of the state regulator in Florida and seeks the assistance of all PIABA members in bringing this issue to the attention of the SEC, NASD and other state regulators.

2) that each member write to both McLucas and all of your state regulators requesting that the SEC and the states force all the major brokerage firms to waive all time bar defenses regarding the sale of limited partnerships from 1980-1991.

[Editor's Note: The Wall Street Journal has reported that the SEC is in the preliminary stages of an investigation of the limited partnership sales tactics of Merrill Lynch and PaineWebber. There is a rumor afoot that NASAA is encouraging a similar investigation. It is vitally important that you show your support of such an investigation to both the SEC and your state regulator.]

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Member Gerald E. Marcus requests information on any penny stock cases against Robert Todd Securities. C ' (203) 248-5444. FAX (203) 288-8777.

* * *

Barry Estell and John Miller, Nygaard & Miller, Overland Park, Kansas, extend their appreciation to PIABA members Jim Beckley, Wheaton, Illinois and Herb Deutsch, Garden City, New York. The Nygaard, Miller firm won a $68,424 arbitration award against Commonwealth Financial Group of Fort Lauderdale, Florida in November 1993. The award included $34,000 in punitive damages. The Respondent, located in Florida, appealed the Missouri award in Cook County Illinois, with a New York law argument, while assuring us he was or soon would be judgment-proof in Florida. Herb tied up the firm's clearing deposits through garnishment in New York giving Jim time to win the appeal in Chicago, received in December, 1994. Thank you gentlemen.

* * *

Richard Mayberry would like to announce a seminar on "Rogue Brokers and their Supervisors", February 17, 1995, 2:30 p.m. at the District of Columbia Bar Winter Convention. The panel includes William R. McLucas - SEC, John E. Pinto - NASD, Dennis A. Klejna - Commodity Futures Trading Commission (CFTC). For additional information, call Richard at (202) 785-6677.

James Keeney of Namack, Clark & Keeney requests information on any litigation pending or contemplated regarding Polaris V which was sold to his client by First Interregional Equity Corporation. Please call Jim at (813) 356-4141 with information.

* * *

We received several inquiries into the viability of any cause of action for settling VMS class members.

Although numerous state court actions by settling VMS investors have been filed seeking retroactive exclusion from the class (based either on lack of notice or misleading information from Prudential about the effects of the settlement), it appears that investors have been uniformly unsuccessful in these efforts. See, for example, In the Matter of VMS LIMITED PARTNERSHIP SECURITIES LITIGATION, 26 F.3d 50 (7th Cir. 1994).

There is a ray of hope, however. A group of Michigan investors have sued Prudential in a separate Michigan state action seeking, not exclusion from the class, but rather for damages occasioned by Prudential's causing the investors to fail to opt out of the class. In a well written 14 page opinion. U.S. District Court Judge Suzanne B. Conlon (N.D. Ill.) refused to enjoin the state court action. Judge Conlon ruled that the state action stated a separate cause of action which was not precluded by the VMS final judgment.

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