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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

June 1995 Volume 2 Number 2

In This Issue...

The PIABA Quarterly

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Editor's Note

Along with this issue of the *Quarterly* we are enclosing an updated list of PIABA members. We encourage you to communicate with each other and especially encourage you to provide fellow members with information in response to requests contained in the "Bulletin Board" section of the *Quarterly*.

Also included in this issue is a registration form for the 1995 Annual Meeting which will be held October 26-28 in the San Diego area. We request that reservations for the Annual Meeting received by June 30, 1995.

The deadline for receiving submissions for the July issue of the *Quarterly* is July 5th. All submissions, regardless of length, should be accompanied by a computer disk of the submitted material.

In the July issue, we intend to provide an outline of information and documents for use in opposing Section 15 motions made by the industry. Please see The Bulletin Board for information.

The PIABA Quarterly is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed are not necessarily those of PIABA or its oard of Directors. Information is from sources deemed reliable, but should be used subject to verification.

Letter From the President

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

The last quarter has been extremely eventful for all of us. Needless to say, the three decisions handed down in the last week of February will forever settle many of the questions with which we've been struggling for so long. (See, article on New York law developments, below.)

But even more important is the **1995 Annual Meeting.** The Board of Directors is pleased to announce that the meeting will be held at the La Costa resort and Spa in Carlsbad, California. La Costa is about 1/2 hour up the coast from the San Diego airport. It has beautiful meeting rooms as well as incredible golf and spa facilities. (See, the article about La Costa, below.)

The meeting will be held on October 26-28. Like last year, there will be three (3) meeting sessions. Because of the West Coast venue, however, we have made some changes to the schedule. The first session will be on Thursday, October 26, but we will begin at 1:30. Friday and Saturday the meetings will run from 8:30 through 1:30 or 2:00 (including luncheon speakers). This schedule will permit members to fly in Thursday morning if they choose, and to leave early Sunday if they wish to do so. Like last year, the evenings will include cocktail parties on Thursday and Friday, and a dinner reception on Saturday night.

As in the past, we will be putting together a program that includes emphasis on both law and practice. I encourage any of you who wish to make a presentation or be a panelist to contact me with suggestions.

Please make your reservations for the Annual Meeting <u>before</u> June 30, 1995. A registration form is enclosed with this newsletter.

In This Issue...

Letter From the President

Letter From the President (con't.)

On a different note, I wish to commend John L. or and Mike Gilmore for their *amicus* brief in Boone (and Jerry Stanley for his appearance at oral argument before the Fifth Circuit), and Mark Maddox and Stu Goldberg for their *amicus* brief in Mastrobuono (I also contributed). Both briefs were winners! Submission of *amicus* briefs is one of PIABA's most important functions.

Best wishes for a warm and prosperous Spring!!.

Seth

The Demise Of Secondary Liability Under the Securities Act Of 1933

Andrew O. Whiteman, HARTZELL & WHITEMAN, LLP

There is no doubt that the U.S. Supreme Court is concerned about the nature of securities litigation in the federal courts. Last year, in Central Bank of Denver, N.A. v. First Interstate Bank, N.A., ___ U.S. ___ (1994), Justice Kennedy wrote that "litigation under Rule 10b-5 prese a danger of vexatiousness different in degree and in ki... from that which accompanies litigation in general." The Court ruled in a five to four decision that a private plaintiff may not maintain an aiding and abetting claim under Section 10(b) of the Securities Exchange Act or SEC Rule 10b-5. The decision represented an abrupt change in established law — every Circuit Court had approved of aiding and abetting liability prior to Central Bank.

This year, Justice Kennedy again authored the majority opinion in another five-to-four landmark decision that restricts the scope of the federal securities laws. In Gustafson v. Alloyd Company, ___ USLW ____, 55 CCH S.Ct. Bull. p. B957 (February 28, 1995), the Court held that Section 12(2) of the Securities Act of 1933, which prohibits fraud in connection with the offer or sale of a security "by means of a prospectus or oral communication," applies only to public offerings and not to private sales or so-called secondary offerings that do not involve a prospectus.

Gustafson and two others sold shares of their closely held corporation to the respondent, Alloyd Co., Inc. The sale was made pursuant to a written contract. After a year-end audit revealed that the company's earnings were lower than had been estimated at the time of sale, the respondent sued for rescission under 12(2) of the 1933 Securities Act. 15 U.S.C. § 77l(2). The respondent claimed that Gustafson and his co-shareholders had made false statements and that the written contract constituted a "prospectus" within the meaning of Section 12(2).

The District Court agreed with the selling shareholders' contention that Section 12(2) claims can only arise out of initial stock offerings. The Seventh Circuit Court of Appeals reversed and remanded in light of a Seventh Circuit case which had construed the term "prospectus" very broadly to include any written communication used in connection with any stock offering.

The Supreme Court accepted the case in order to reconcile a split of authority between the Circuit Courts. Compare Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d. 682 (3d Cir. 1991) with Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc., 993 F.2d 578 (7th Cir. 1993). The Court then addressed the issue before it by reviewing the statutory language "prospectus or oral communication" and other provisions of the 1933 Act.

The first point made by the Court was that the term "oral communication" is restricted to oral communications that relate to a prospectus. That much was apparently conceded by both parties. Thus, the question is whether the term prospectus is broad enough to encompass a written contract made in connection with a privately-negotiated stock sale.

The Court reviewed other parts of the Securities Act — Sections 2(10), 10 and 12 — and found that in those sections the term "prospectus" referred to documents related to public offerings made by an issuer or its controlling shareholders. The Court concluded that Congress must have intended that the word

The PIABA QUARTERLY is published quarterly in the interest of the members of The Public Investors Arbitration Bar Association. Editor-In-Chief - Jerry Stanley; Associate Editor - Seth Lipner. The PIABA QUARTERLY welcomes information on cases or articles that would be of interest to PIABA members. Contributions should be mailed to:
The PIABA QUARTERLY, 7909 Wrenwood Boulevard, Suite C, Baton Rouge, Louisiana 70809; FAX (504) 926-4348. All copy is subject to the approval by the publisher. Any material accepted is subject to such revision as is deemed appropriate in the publisher's discretion.

mean the same thing in Section 12. The Court then held that the written contract between petitioners and respondent was not a prospectus because it did not contain the information required to be included in a registration statement.

The Court refused to accept respondent's argument based on Section 2(10)'s definition of prospectus as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television." 15 U.S.C. § 77b(10). According to the majority, rules of statutory construction indicate that the definitional phrase was meant to refer to communications made in connection with a public offering of stock. The phrase "prospectus, notice, circular, advertisement or letter" refers to documents of wide dissemination, but not face-to-face or telephonic conversations.

Justice Kennedy felt that a restrictive reading of Section 12(2) was supported by public policy considerations. While it is understandable that Congress would provide buyers with a right to rescind, without proof of fraud or reliance, in a document "prepared with care" in connection with a public offering, Congress did not intend to create broad liability for "every casual communication" between a buyer and a seller. This section is clearly the weakest part of the opinion — it is highly unlikely that the written agreement at issue in the case, involving an $18 million stock sale, was prepared without proper thought to the legal consequences of the transaction. The extensive representations and warranties contained in a typical stock sale agreement hardly constitute "casual communications" of the type referred to by Justice Kennedy.

The SEC and four justices (Thomas, Scalia, Ginsburg and Breyer) opposed the position adopted by the majority. The dissenters relied principally on the expanded definition of "prospectus" contained in Section 2(10). Justice Kennedy responded to those criticisms with persuasive citations to the legislative history of the 1933 Act. Justice Thomas made the important point that, under the majority's reasoning, offerings that are exempted from Section 5's registration requirements (e.g. non-public offerings) are beyond the scope of Section 12(2) because no prospectus is required.

The importance of the Gustafson decision is enormous. Lower courts and commentators had accepted the proposition that Section 12(2) applied to aftermarket trading as well as public offerings. See [F]rley v. Baird, Patrick & Co., Inc., 750 F. Supp. 1209 (S.D.N.Y. 1990); Louis Loss & Joel Seligman, Securities Regulation pp. 4217-4222 (1992). The statute creates strict liability for material misrepresentations or omissions of fact as long as the plaintiff did not now of the untrue statements or omissions when he purchased the securities. Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970).

Most importantly, there is no intent requirement for Section 12(2) violations. Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222 (7th Cir. 1980), cert. den. 450 U.S. 1005 (1981); Franklin Sav. Bank of N.Y. v. Levy, 551 F.2d 521 (2d Cir. 1977). A defendant will be held liable unless he proves that he did not know or in the exercise of reasonable care could not have known of the omission or misstatement.

In contrast to an action brought under Section 10(b) of the Securities Exchange Act, a plaintiff proceeding under Section 12(2) does not have to demonstrate reliance or causation, but merely that he "did not know" of the omission or misstatement. Johns Hopkins University v. Hutton, 422 F.2d 1124 (4th Cir. 1970) (no reliance required); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971) (causation not an element). Plaintiffs have no duty to investigate beyond general knowledge. Id.

The Supreme Court's restrictive reading of Section 12(2), limiting its scope to public offerings, leaves Rule 10b-5 as the principal federal remedy for stock fraud in non-public transactions.

A strict liability theory may be available under state Blue Sky laws. The anti-fraud provision of the Uniform Securities Act is modeled on Section 12(2) but is not limited to public offerings. Section 410(a)(2) of the Uniform Securities Act broadly prohibits the offer or sale of securities by means of untrue statements or omissions of material fact. A defendant is liable unless he can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." As Justice Ginsburg pointed out in her dissent, the "legislative history" behind the Uniform Securities Act indicates the drafters of Section 410(a)(2) intended the provision to have the same meaning as Section 12(2). Therefore, claimants should be able to argue that proof of intent to defraud and reliance is not required for a claim brought under a state statute modeled after the Uniform Securities Act.

Recent New York Court Decisions

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

The last week of February saw two (2) important court decisions from New York, and, of course, the Mastrobuono decision from the U.S. Supreme Court.

The first decision from New York, Smith Barney v. Luckie, was from the New York Court of Appeals, the state's highest court. The investor had demanded arbitration at the NASD, and the firm had claimed that the arbitration was barred by the statute of limitations (as opposed to "eligibility".) The firm had relied on the combination of (1) a New York choice-of-law clause and (2) a New York procedural statute (CPLR 7052) authorizing one against whom arbitration has been demanded to petition the courts for an order staying arbitration if the claims are barred by limitations of time.

In its decision, the Court of Appeals held that Smith Barney could avoid having to arbitrate "timeliness" issues — specifically statutes of limitations defenses — because their standard-form customer agreements contained a New York choice-of-law clause. The Court, in so ruling, seized on the language of the choice-of-law clause, which provided that New York law shall govern "the agreement and its enforcement." The Court rejected the lower court view that CPLR 7502 was pre-empted, and it expressly distanced itself from the prevailing rule in federal court, that the FAA d[illegible] in fact, pre-empt CPLR 7502.

Interestingly, Chief Judge Judith Kaye authored a separate concurring opinion. In that opinion, Judge Kaye stated that she felt compelled to join the majority because of the Volt case, but, she wrote, that case signaled the erosion of the pro-arbitration policies of the FAA. Judge Kaye also expressed her concern that these out-of-state investors (Mrs. Kahn from Florida, Mrs. Manhard from Virginia) would have to first litigate limitations claims in New York (what this author calls the "litigation pit stop") before being permitted to arbitrate. Chief Judge Kaye's expression of concern, which apparently was not sufficient to influence the outcome in Luckie, is especially important when the subject moves to the second case decided in February 1995, Merrill Lynch v. McLeod. (See, below.)

The Court of Appeals, having reversed the decision of the Appellate Division in Luckie and Manhard, remitted the case to the lower court for a determination of the limitations issues as applied to Mrs. Kahn and Mrs. Manhard. In doing so, the Court of Appeals reminded the lower court that (1) under New York law, a claim for securi[illegible] fraud arose where damage occurred (i.e., where the investor resides), but (2) that New York must also import that state's provisions on accrual, tolling, etc.

The Luckie decision is in seeming conflict with Mastrobuono, and we have filed a motion to reargue based upon Mastrobuono. It should be noted, however, that the choice-of-law clause in Mastrobuono did not include the words "and its enforcement." We expect the industry to seize on those three little words (as the Court did in Luckie) and argue that Garrity still applies when the agreement contains the "and its enforcement" language.

The Luckie decision was a blow to investors, who are now threatened with a two-stage proceeding, first in court then in arbitration. In view of the fact that in securities cases, issues of knowledge, etc. are often at the center of the case, the Luckie decision will often require duplicative proceedings. In spite of the fact that the Luckie decision was a blow to investors, its impact was lessened substantially by the McLeod decision 3 days later.

Merrill Lynch v. McLeod, combined with Judge Kaye's comments in Luckie concerning the burdens of the "litigation pit stop", seem to have settled once and for all the question of whether New York has jurisdiction over out-of-state investors by virtue of the fact that the NASD and NYSE are in New York. McLeod is the first case from a New York appellate court to decide the jurisdiction question. The court sided with the investor, calling the practice of dragging in out-of-state investors "unfair." The court rejected any argument that the mailing of an arbitration claim to New York was sufficient, on the basis of consent or long-arm, to establish jurisdiction over nonresidents who did not transact business at a New York brokerage branch.

At the time of this writing, Merrill Lynch has not decided whether to seek leave to appeal. As stated earlier, however, in light of Chief Judge Kaye's comments in Luckie, and in light of the persuasiveness of decisions like Luckie, Samples, and McLeod, the jurisdiction fight has ended. To the extent that Justice Solomon had made a similar ruling in Merrill Lynch v. Barnum, the door to the New York courthouse has effectively been closed (in out-of-state investor cases) since September. McLeod assures that the door will remain closed.

Investors lost the Luckie battle, but eventually won the war. The casualties are Doris Kahn, Margaret Manhard, and New York resident investors.

Supreme Court "Masters" Punitive Damages

Ma ̄. Maddox, COONS, MADDOX, & KOELLER

As a resident of the Seventh Circuit, no one was more relieved than I to hear about the Supreme Court's 8-1 decision reversing the Seventh Circuit's holding in Mastrobuono. Not only did this case effect all of the customer cases that we had been filing the last year, but it directly effected another case in which we had a punitive damage award before the Seventh Circuit for confirmation/vacation. For the near future, those of us who work primarily outside the State of New York have compelling authority in Mastrobuono for cases with customer agreements that include choice of law clauses. In the Seventh Circuit, we also have good authority in the Baravati case for those situations in which there is no customer agreement between the parties.

Although some of our colleagues have declared Garrity to be dead as a result of Mastrobuono, the announcement of Garrity's demise may be premature. It is likely that this issue will need to be addressed either in New York State court or in the Second Circuit before we can bury Garrity once and for all.

Some have expressed concern that the securities industry will simply try to modify its customer agreements in order to better disclose the election of New York's Garrity rule prohibiting punitive damages in arbitration. However, I believe this will be unlikely. The NASD has already warned its members against this through its Notice to Members 95-16 sent out on March 22, 1995. You can receive a full copy of this Notice by contacting Samantha Rabin at the Securities Arbitration Commentator.

In addition to the likely battles in the State of New York as to the death of Garrity, it is most likely that the battle ground relating to punitive damages will now shift to the various rule-making bodies of the arbitration forums. Specifically, the NASD and the New York Stock Exchange have been conducting internal reviews of their respective arbitration forums that may lead to recommendations for revising their rules. Among rule changes being considered by these forums is capping punitive damages pursuant to some calculation, or possibly prohibiting punitive damages all together, possibly with an option for th vestor to elect the courthouse if they decide to seek punitive damages. PIABA representatives have made presentations to these respective committees, and will monitor their activities closely.

One final note, the most immediate threat to investors recovering punitive damages in my view is the pending litigation reform measures before Congress. If you haven't done so already, please contact your respective Senators and encourage them to oppose this legislation. You may want to contact certain of your clients and encourage them to contact their Senators as well.

Mastrobuono and Section 15

John N. McKeegan, SHOCKMAN & McKEEGAN

Although the Mastrobuono decision focused on the validity of punitive damages awards, we have cited it in a Section 15 dispute in a case against Merrill Lynch.

We asserted that the rules of construction employed by the Supreme Court are equally applicable to a "six-year rule" analysis. Just as in Mastrobuono, "it seems unlikely that ... [customers] had any idea that by signing a standard-form agreement to arbitrate disputes they might be giving up an important substantive right, "i.e., the right to rely on applicable statutes of limitations. As you know, many state statutes of limitations have "discovery" provisions that would permit claims to be asserted more than six years after the investment at issue. Further, the Court explicitly followed the Restatement's view that "there is substantial reason for preferring the meaning of [the customer]" when interpreting form agreements; we contended that Merrill Lynch's interpretation of Section 15 would cause an "unintended or unfair result" which this rule of construction seeks to avoid.

There is some peril in making this argument, of course, because Mastrobuono also relies on the pronouncement in Volt Information Sciences, Inc. v. Stanford, 489 U.S. 468 (1989) that parties may "specify by contract the rules under which [an] arbitration will be conducted", and proceeds to interpret the NASD Code of Arbitration Procedure as if incorporated by reference in the form agreement.

NASD Notice to Members 95-16

The NASD recently issued its pronouncement regarding the increasingly one-sided customer agreements that many industry firms are requiring customers to sign. Stating that "it has come to the attention of the NASD and the SEC that customer agreements used by some NASD members contain provisions that are inconsistent with NASD Rule 21(f) or that subvert its purpose...", the NASD Notice to Members 95-16 went on to encourage members to "take prompt steps to ensure that their customer agreements fully comply with this important rule and the Code of Arbitration Procedure."

The Notice lists five specific areas of concern: hearing location; arbitration panel composition; time limitations; claims and awards; and other.

Importantly, the Notice quoted from the SEC's *amicus* brief in Mastrobuono in which the SEC opined that Rule 21(f) "has the force of federal law and precludes the enforcement of contractual provisions that are inconsistent with its terms."

The Notice flatly states that "Where the governing law clause is used to limit an award, it violates Section 21(f)..".

Smith Barney, with its "New York law without regard to choice of law" language and its federal statute of limitations provision was apparently the catalyst for the Notice, but virtually all firms attempt to restrict investors rights in their account agreements in violation of Rule 21(f).

Recent Congressional Legislation

As most of you know, the House has passed H.R. 1058, the Securities Litigation Reform Act. The bill as passed makes significant changes, among them:

1) Intent to Defraud Standards. The House measure provides that in any private securities suit (either individual or class action), liability against a defendant may be established (and the suit may proceed) only on proof to the court by the plaintiff that the defendant acted knowingly or intentionally. Specifically, plaintiffs must show the court that the defendant:

- Directly or indirectly made a fraudulent statement (defined as either an untrue statement or fact or an omission of a necessary fact); and
- Possessed the intent to deceive, manipulate, or defraud; and
- Made such fraudulent statement knowingly or recklessly.

(Under current securities law, there are no specified standards that must be met by plaintiffs in showing that a defendant acted with the intent to deceive or defraud — i.e., a showing of "scienter". Rather, courts have repeatedly determined that a defendant who acted recklessly is deemed to have acted with the intent needed to proved securities fraud.)

2) Definition of "Recklessness". Under the measure, "reckless" conduct as evidence of intent to defraud would be defined as a statement by a defendant to a buyer or seller that is highly unreasonable, involves an extreme departure from normal standards, and presents a danger of being misleading that is either known by the defendant or is so obvious that the defendant must have been aware of the danger. (Current securities law does not define recklessness.)

The bill also provides that "deliberately refraining" from taking steps to discover whether a statement is false or misleading would be considered reckless behavior, however, a broker whose failure to investigate that was not deliberate would not be considered reckless. (Emphasis ours.)

3) "Loser Pays". The bill establishes a principle of "loser pays" for private (i.e., non-governmental) securities lawsuits, which is intended to further discourage the filing of frivolous and baseless lawsuits.

Under the measure, courts would be required to order the payment of reasonable attorneys' fees and other expenses to the prevailing party (either the plaintiff or defendant) in any case that is not settled out-of-court — if the court, upon a request by the prevailing party, makes the following three determinations:

- the case of the losing party was not justified; and
- that requiring the losing party or that party's attorney to pay such costs would be just; and
- the cost of attorneys' fees and other expenses to the prevailing party was "substantially burdensome or unjust."

In ordering losing parties to pay such costs, courts would have discretion in determining how such payments are to be allocated between the losing party and its attorneys.

4) Class Actions. In the case of class action suits, the bill also requires that plaintiffs and/or their attorneys post a bond or other financial security to ensure the payment of the defendants' legal fees and expenses should the plaintiffs lose, and attorneys' fees be awarded to the defendants. The measure includes no similar requirement for defendants.

5) Forward-Looking Statements. The bill exempts from liability those defendants whose private (i.e., non-governmental) securities fraud cases are based on certain published or orally-presented information concerning the expected future performance of a company (so-called "forward-looking statements").

Under the measure, such an exemption from liability would apply to financial estimates, projections, and descriptions of future events — made either orally or in written documents — provided it is clearly noted on the documents or understood orally that such estimates or projections may not be realized. The bill generally provides that persons providing such statements are not obligated to update them.

If a defendant claims the allegedly fraudulent misleading statement or omission is in fact an exempted "forward-looking" statement, the bill requires courts to suspend the discovery process until the court can hold a hearing on the claim, and it also requires the SEC to adopt certain rules and regulations concerning such "safe harbors" for forward-looking statements.

6) Abusive Litigation Practices. The bill includes numerous provisions intended to prevent abusive litigation practices by plaintiff attorneys, including those that would:

- prohibit securities brokers and dealers from soliciting or accepting payments from attorneys for helping such attorneys find clients to represent in securities lawsuits;
- prohibit bonus payments (except for certain expenses) to named plaintiffs in class actions by requiring that such persons receive a per share settlement equal to the settlement awarded all other members of the class.

7) Use of the RICO Statute. The measure expressly prohibits the use of the RICO statute for bringing any civil lawsuit in which the alleged racketeering activity involves securities fraud. As you know, under RICO, triple damages and attorney's fees may be ordered in cases where patterns of violations exist.

*** It is important to note that the Senate is now considering companion legislation in the "Lawsuit Reform Act of 1995". We strongly encourage each of you to take the time to contact your Senator to express your concerns about the effect of these provisions should they become law. A call to your state securities commissioner to encourage him to make similar contact with your Senator could also be effective.

Update on Prudential Expedited Arbitrations

David Hirschberg, HARTZELL & WHITEMAN, LLP

At the PIABA annual meeting in October, I reported that our firm had filed on behalf of our clients, approximately 100 requests for expedited arbitration as a result of Prudential's refusal to make settlement offers during Stage 1 of the expedited claims resolution process. The following is a summary of our firm's experiences with these expedited arbitrations:

As of April 1, 1995, 77 of these claims have been resolved. Hearings were held for 7 of the claims, all of which resulted in awards for the "maximum amount available" as determined by the Claims Administrator and Prudential. While we continue to disagree with the Claims Administrator's method of determining these "maximum amounts", the arbitrators we have been before have reiterated to us that they are bound by these figures and will not accept evidence on the issue of a given partnership's actual value as compared to the ascribed "residual value". The "maximum amount" figures are now available upon request to the Claims Administrator, the arbitrator or Prudential's 800 number.

Another 7 claims were settled by Prudential after they were assigned to an arbitrator but before a hearing was scheduled. Approximately 63 claims were settled after the hearing commenced. These claims all involved the same account executive and were consolidated for hearing. On the first hearing day the account executive testified on behalf of the claimants and identified numerous

Prudential marketing materials he received (and kept after leaving the firm) which contradict the prospectus discl es. An expert witness also testified as to his analysis of the various partnerships involved in the consolidated claims based upon his review of the prospectuses. Both witnesses were vigorously cross-examined by Prudential's counsel. At Prudential's request, the testimony of these two witnesses was transcribed, but the arbitrators refused to allow transcription of the testimony of customers. Prudential then sought a review of this determination by the Claims Administrator. Their request was again denied, at which point Prudential settled the claims.

The settlement amounts appear to have been based more on the particular partnerships purchased than on the background of the claimants. For example, most claimants were offered the "maximum amounts" for their Energy Income purchases regardless of the claimants' income, net worth or investment history. Certain other partnership purchases resulted in a wide range of offers. In any event, I believe I would not have received any settlement offers in these cases had the account executive not testified for the claimants <u>and</u> had the marketing materials not been introduced. The arbitrators (a panel of four for these consolidated cases) appeared very interested in th come projections and misrepresentations of safety contained in the "broker use only" marketing materials, which the account executive testified he relied upon in recommending the partnerships to his customers. It has been our experience that the arbitrators are unwilling to accept Prudential's marketing materials into evidence without the testimony of an account executive that he actually received them and relied upon them.

As noted above, an account executive who testifies on behalf of the claimant will be vigorously cross-examined by Prudential, primarily on the issue of whether his reliance upon the marketing materials rather than the prospectuses was appropriate. However, the arbitrators we have been before understand that Prudential is bound by the acts or omissions of its account executives and have questioned Prudential's counsel about the relevance of this line of cross-examination. Prudential's cross-examination of the claimants will focus on any discrepancies between their testimony and their claim form and any information bearing on their financial sophistication, such as speculative trading in their account. In most of our cases any speculative trading represented a very small percentage o eir portfolio (and a much smaller percentage than their limited partnership purchases represented). In any event, the arbitrator should be reminded that no degree of investor sophistication can give Prudential license to fraudulently misrepresent the risks and anticipated returns of their limited partnerships.

Most of our remaining claims involve brokers who will not testify on behalf of the claimants. In these cases we have requested that Prudential produce marketing material as well as commission runs and the account executive's amended Forms U-4 and U-5, which will disclose other limited partnership claims, settlements or awards. In some cases Prudential has supplied all the requested documents. In other cases they have provided nothing, forcing us to pursue the matter with the arbitrator or subpoena the NASD to obtain the broker's CRD Record. Prudential also responds to document requests by producing its own request for production of the claimants' tax returns, account statements from other brokerage firms and identification of fact and expert witnesses.

Finally, we have encountered several situations where limited partnership purchases listed on the claim forms were omitted from the arbitration submission agreement and/or Prudential's legal reply. A variety of reasons have been given for these omissions, but if the arbitrator's file does not include these partnerships he will not allow testimony at the hearing with respect to them and will not include them in the award. I suggest that the list of partnerships appearing in the expedited arbitration submission agreement be compared to those included in the claim form before the submission agreement is filed. In addition, the list of partnerships included in the claim should also be confirmed with the arbitrator upon notification of his assignment to the claim.

Merrill Lynch "Broker Use Only" Sales Information Now Available on Computer

Those of you with limited partnership cases against Merrill Lynch should be interested to know that virtually all "broker use only" notes used in the sale of previous Merrill Lynch limited partnerships are <u>currently</u> available and can be accessed and printed from any computer in any Merrill Lynch branch office. If you specifically request the information and make Merrill aware that you know it can be retrieved from computer, they have no choice but to produce it during discovery. For more information, contact Director Jerry Stanley at (504) 926-1400.

Technology Committee 'pdate

The PIABA Technology Committee has recently been formed. Members of this Committee currently include Mark Maddox (chair), Joe Long and Thomas Benson. The Technology Committee will be reviewing a proposal from LEXIS Council Connect to operate a bulletin board and E-Mail program for PIABA members. This proposal will be submitted to the PIABA Board of Directors for consideration at its Spring meeting which is to be held in Naples, Florida, the last weekend in April.

If anyone desires to join the PIABA Technology Committee, please contact Mark Maddox at (317) 574-2043.

NASD Arbitration Caseloads are up... But...

The number of arbitrations filed at the NASD was at an all-time high in 1994 — 5,570 cases — up 3% from 1993. But the number of securities arbitration cases filed with other forums declined, suggesting that the increase at the NASD is a result of the NASD picking up cases from other arbitration forums.

At the NYSE, 710 cases were filed in 1994, down from 809 in 1993 and a record 1,623 in 1988. AAA had 273 cases filed in 1994, less than half the record 635 cases filed in 1993. At the AMEX, 68 cases were filed in 1994, compared with 48 in 1993, and the 107 case record in 1988.

Arbitral Award on State Claims Did Not Bar 10 b-5 Claims

In Wolf v. Gruntal & Co., Inc. (reported at CCH ¶ 98,520), a customer's antifraud claim against a brokerage firm was not precluded by an earlier arbitral award to the customer on his state-law claims against the firm. The United States First Circuit Court of Appeals deferred to the "emphatic" choice-of-law provision in the customer agreement in this case, but also stated that the doctrine of *res judicata* is not applicable if the forum which rendered the prior "judgment" (the arbitral award) lacked "jurisdiction" over the 10b-5 claim. The Court held that the Arbitral tribunals' authority over particular claims is determined by contract.

The customer agreement expressly provided that all non-federal securities disputes were to be arbitrated, but conferred no arbitral authority over the Rule 10b-5 claim. Nor did the agreement require the customer to initiate an arbitral "submission" encompassing the antifraud claim. Under state law, absent a bilateral, written submission, an arbitral forum could not acquire "jurisdiction" over the securities fraud claim. Consequently, the arbitral award could not preclude later litigation of the antifraud claim in federal district court.

Aiding and Abetting Supports RICO Claims

In Dayton Monetary Assoc. v. Donaldson, Lufkin, & Jenerrette Sec. Corp. (SD NY, CCH ¶ 98,527), limited partnership investors were able to maintain RICO claims over an objection that aiding and abetting the commission of a predicate act cannot constitute racketeering activity under RiCO. In making that argument, the defendant brokerage firm relied on the U.S. Supreme Court's decision that civil liability under the 1934 Act does not include those who aid and abet a Section 10(b) violation (Central Bank of Denver v. First Interstate Bank of Denver, (CCH ¶ 98,178).

According to the District Court, dismissal of the RICO claims would have overstated the reach of the Supreme Court's decision. The Court reasoned that whether racketeering activity has been committed depends on a finding of criminal liability for a given act, not on finding of civil liability. An individual who aids and abets a federal crime is treated as a principal. Once the individual is guilty as a principal in the prohibited racketeering activity, the aider and abettor faces the civil liability imposed by the RICO statute.

Court Order On Arbitral Hearing Contravened Arbitration Act

In Merrill Lynch, Pierce, Fenner & Smith, Inc. v Lauer (CA-7, CCH ¶ 98,636), the Seventh Circuit held that the district court (ND Ill.) had exceeded its authority by issuing an order to eliminate claims in an arbitration proceeding in another district. The customers had initially filed an NASD demand for arbitration of their churning, unsuitability and other claims against the firm and the account representative, pursuant to the customer agreement (the customers had lived in Illinois at the time the trades occurred but later moved to Florida.) After the NASD selected Florida as the arbitration site and set a hearing date, and after both sides commenced discovery, the brokerage firm brought an action in the Northern District of Illinois. The Illinois district judge refused to compel arbitration in Illinois, but ordered the customers to eliminate their punitive damages claim and any claim more than six years old in the Florida arbitration.

After stating that the district judge was correct in his conclusions regarding the effect of Seventh Circuit l[illegible] on the punitive damages and "stale" claims, the Appeals Court held that the lower court's order regarding the Florida arbitration proceeding contravened the language and purpose of the Federal Arbitration Act. Section 4 of the Act, which permits a party to petition the court for an order compelling arbitration on the proper terms, "clearly requires a 'geographical link' between the site of the arbitration and the district which, by compelling arbitration or directing its scope, exercises preliminary control." The section mandates that a court-ordered arbitration proceed within the district in which the petition for the order is filed. The mandatory language of the section thus "ties the location of arbitration to the district in which the motion to compel is brought." Conversely, the Seventh Circuit reasoned, where the location of arbitration is pre-ordained, the statute limits the jurisdiction in which Section 4 motions can be brought.

The BULLETIN BOARD

We all should be concerned with the increasing number of court decisions (and arbitrator decisions) which incorrectly hold that NASD Code of Arbitration Procedure Section 15 is a "substantive statute" which defines the jurisdiction of the arbitrators, and, as such, is an issue to be decided by the courts, and, because of its substantive nature, cannot be tolled by fraudulent concealment or other equitable considerations.

In the July issue of the *Quarterly*, we intend to provide an outline of information and supporting documents that have been successful in demonstrating that Section 15, from its inception, was and is a procedural provision. Please send us all of your best Section 15 material — your best brief; the minutes of any NASD meetings on Section 15; any NASD or SEC pronouncements or letters on the subject; and any other information or documentation which has been effective for you in overcoming a Section 15 motion by the industry. Also, those of you that have been on the wrong end of a Section 15 motion, please send us a copy of your statement of claim, the motion to dismiss filed by the firm, your response to the motion and a copy of the decision.

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We want to increase member awareness about arbitrators who members feel are not fulfilling their role as arbitrators properly. We request that all members send us the names of arbitrators against whom, based on your experience, they would exercise a peremptory challenge. Include the local at which these arbitrators regularly serve. We will publish the list quarterly, so that members can use this information accordingly. The publication of this list will begin with the Summer newsletter.

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Deutsch & Lipner has cases against Dickinson Securities involving a stock called Conversion Industries. If you have any information, please call. They also have a case against a broker named Mark Glasser at PaineWebber involving CMO pools. If you have any cases against Glasser, please call.

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Jerry Stanley has a limited partnership case against Merrill Lynch in which Merrill has designated Allen Rockler of Beverly Hills, CA, as its expert witness. It appears that Mr. Rockler represents that his expert appearances are divided 50-50 between customers and the industry. Anyone who has used Mr. Rockler on the customer side or faced him as an expert for the industry is requested to call Jerry at (504) 926-1400.