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The PIABA Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

June 1997 Volume 4 Number 2

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Editor's Notes

This issue of the Quarterly contains sections of two feature articles — the second half of Joe Long's article "Back to Basics" and the first half of Tim O'Connor's article on SEC Decisions as Precedent in Arbitration.

The deadline for receiving submissions for the September 1997 issue of the Quarterly is September 5, 1997. All submissions, regardless of length, should be accompanied by a computer disk of the submitted material in either Word Perfect or as a text file.

Please send change of address information to Robin Ringo, 1111 Wylie Road, #18, Norman, OK 73069, Phone (405) 360-8776, E-mail: PIABA@mindspring.com.

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 Board of Directors. Information is from sources deemed reliable, but should be used subject to verification.

Letter From the President

Rosemary Schockman SHOCKMAN & MCKEEGAN, P.C.
Scottsdale, Arizona

Dear Colleagues:

We are moving ahead with plans for the Annual Meeting. The Directors are participating in a lengthy conference call on July 11 to refine the agenda. Thanks to the PIABA members who transmitted suggestions for the program. We are incorporating many of your ideas.

Mitch Perlstein, one of our members in Florida, has brought to our attention what is becoming a new policy of the NASD. When early pre-hearing conferences are held, the NASD is suggesting to arbitrators that hearing session fees be set and collected for the entire arbitration proceeding. In Mitch's case, he suggested the hearing would be about two days. Respondents requested additional days. The arbitrators set a hearing for several days, and ordered payment of all fees in a short period of time. One half the anticipated fee, $2,200, was required of the claimant.

The PIABA Board of Directors is extremely concerned about this policy change. Mitch's case was not a large damage case. Imposi-

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tion of these large advance fees has an extremely chilling effect on the ability of the claimant to seek redress.

I subsequently had a conference with Deborah Masucci, Vice President/Director of Arbitration, and Linda Fienberg, Executive Vice President, to discuss the NASD policy shift, which is particularly disturbing in light of the recent decision of the D.C. Circuit in Coles v. Burns.

The NASD will typically seek all hearing fees in advance. If the case is settled eight days or less before the hearing, THE FEES WILL NOT BE ROUTINELY REFUNDED. Claimant will have the ability to apply to the arbitrators for some refund. Refunds will not be routinely given even though the arbitrators will not always receive the fees the parties have paid in advance. Rather, the fees are being viewed by the NASD as part of its average or anticipated cost of doing business.

The PIABA Board believes this is an issue of utmost concern, and we are working to address the problem. Please let us know of instances in your own practices in which advance fees are being required.

Several members of the Board and I will be meeting with Linda Fienberg and Deborah Masucci in Denver on July 23, to discuss other issues of concern to our members.

Some of you may have seen Jane Bryant Quinn's recent columns in which PIABA was mentioned favorably as a source of attorneys for claimants in securities arbitration. Robin Ringo reported that she received several requests for lists of attorneys in particular areas of the country after the columns appeared. Lists of PIABA members practicing in the area in which the inquirer resided were provided by her.

Please do not delay signing up for the Annual Meeting. I look forward to seeing you in Scottsdale in October.

Rosemary J. Shockman

FROM THE PROFESSOR
Back To Basics, Part 2

by Joseph C. Long

This is the second of a two part Article, the first part of which appeared in the March 1997 issue of the Quarterly.

In the March issue, this column discussed the selection of state arbitration acts such as the Uniform Arbitration Act or the FAA as it effects such issues as the award of punitive damages and the statute of limitations.[1] In this issue we continue that discussion as to the award of attorneys' fees and pre- and post-judgment interest.

Attorneys' Fees

Recovery of attorneys' fees presents a similar problem to that considered in the March issue where we discussed the statute of limitations. The American Rule is that attorneys' fees are not recoverable.[2] Even though there is limited authority indicating that the American Rule does not apply in arbitration,[3] the right tq recover attorneys' fees, normally, is going to be granted by statute.[4] The federal securities acts do not allow the recovery of

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attorneys' fees as a matter of course,[5] but Section 10 of the state Uniform Securities Act does.[6] Further, the better authority indicates that the award of such fees is mandatory not discretionary.[7]

However, the power of the arbitrators to award such fees is another matter. New York law[8] and Section 10 of the state Uniform Arbitration Act[9] prohibit the arbitrators from awarding attorneys' fees unless the arbitration agreement specifically allows such award.[10] Again, under the FAA, the courts have routinely confirmed the award of attorneys' fees for services performed in arbitration.[11] Thus, again selection to be governed by the FAA, can alleviate any problem here.

Ah, but then comes the rub. Most of us assume that the court can then award further attorneys' fees for confirmation, defending vacatur action, or on further appeal. Under the Section 14 of the state Uniform Arbitration Act, it appears that such fees can be paid.[12] However, the answer is not as clear under the FAA. Cases can be found where the courts have allowed, without discussion, such fees on confirmation or defense of vacatur action.[13] However, in the only case to discuss the point, the Seventh Circuit, Menke v. Monchecourt,[14] has specifically held that, while the state securities acts may give the claimant the right to receive these fees on appeal, the FAA does not give the court the power to award them. The Seventh Circuit said:

> We agree with the district court that there is nothing in the Federal Arbitration Act which provides attorneys' fees to a party who is successful in seeking confirmation of an arbitration award in the federal courts. Thus, without Congressional authority, the district court had no power under the statute to award Menke any additional attorneys' fees she incurred in commencing this action for confirmation.[15] Thus, in confirming Menke's award, the district court was not free to consider whether an additional award of attorneys' fees would be appropriate. Had it done so, the district court according to Schlobohm, would have essentially made an unwarranted modification of the arbitrators' award inconsistent with its limited review under the Federal Arbitration Act. Therefore, we conclude that the district court was correct in not adding into its confirmation judgment any additional attorneys' fees Menke incurred in bringing this action. 17 F.3d at 1010.

A similar result was reached in a state case the author was involved in decided under the FAA.[16]

This leaves us in a dilemma. If the courts, state or federal, do not have the power under the FAA to award these fees, then are these fees simply not recoverable or must they be awarded by the arbitrators?

These fees should be recoverable. As the Court said in Mitsubishi Motors Corp. v. Soler Plymouth, Inc.:[17]

> By agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than in a judicial, forum.

This leads to the next question. Should these fees be awarded by the arbitrators at the time of the initial arbitration? It is standard practice in some states, such as Texas, for the trial court to award attorneys' fees on appeal at the time of judgment. Should the same practice be followed in arbitration in all states or should the case be returned to the arbitrators after completion of the confirmation process? If the latter course is followed, should the determination be made by the original arbitration panel or should the matter be treated as a new arbitration, requiring a new submission agreement?

There appears to be no clear cut answer to these questions. In the case in which the author was involved,[18] the trial court held that the case should be returned to the original panel of arbitrators for determination of the amount of the fees due in successfully defending the award in the vacatur action, both in the trial court and on appeal. The trial court so ordered, and it appears that the NASD will honor that order.

The author believes this is the appropriate way to handle the issue. The Texas system of awarding attorneys' fees for the appeal before such appeal has been filed or completed seems to be an awkward approach at best. At the time of the original arbitration, there is no indication that either a confirmation or vacatur proceedings will ever take place, much less any kind of rational way to determine how much attorneys' time will be involved.

Treating the amount of fees as a new arbitrable issue and sending it to a new panel also seems to involve additional unnecessary paper work and does not provide efficiency in the use of the arbitrators' time and resources. However, the procedure of returning the matter to the original panel appears to run contrary to the concept that once the arbitration award has been rendered, the arbitrators are discharged.

It may be possible to resolve this problem at the time of award. The plaintiff should ask the original arbitration panel to indicate in its original award that the plaintiff is entitled to receive attorneys' fees incurred in post-award confirmation or vacation proceedings.[19] The panel might also be asked to include an determination of the proper rate of compensation for such fees. Also the arbitrators should be asked to include in their award an explicit statement that they are retaining jurisdiction to determine such fees. This would make it clear that the fees are to be assessed and that the original panel intends to award them upon completion of the ancillary proceedings.

In the alternative, it might be possible for the panel to delegate to the court hearing the ancillary proceedings to determine such fees.[20] In such case, the arbitrators may wish to provide the court with the compensation standard in the arbitration award.

The author would appreciate hearing from other members on this issue. If you have faced this problem, let me know how it was resolved. Or, if other members have suggestions as to how to resolve the problem, the author would like to hear from you.

Before leaving the attorneys' fee problem, the author would like to raise a corollary issue. Most if not all of us handle our cases on either a fully or partially contingency fee basis. In such case, it is not fair to base fee recovery from the broker or agent on a strict hourly basis. An hourly award does not cover the contingent risk assumed by the plaintiff's attorney. The author's experience has been that the amount recovered from the defendant by way of attorneys' fees is added to the other award, and the total pot divided according to the contingency fee arrangement. This approach has its problems.

First, there is an ethical question about fee splitting with a layman in those rather rare instances where the attorneys' fee award exceeds the award. Second, this arrangement is not totally fair to the client because he has not been made whole and returned to the position that he was in before the securities were purchased.

It is clear that Section 410 of the Uniform Act has its goal of returning the purchaser to the status quo ante, with interest on his money, and all expenses paid. To do this, the arbitrators should be asked to award the attorneys' fees on the basis of the contingent fee charged rather than an hourly rate. Thus, the total compensation award should be increased by an amount which will allow the client to recover his original investment, interest on his money, and any other expenses incurred, plus pay his attorney his entire contingent fee.[21] Only if this is done will the client be made whole. While it is clear that the arbitrators are not bound by the contingency fee agreement, it is clear that it is proper for them to consider it when setting the fees the plaintiff may recover.[22]

If the arbitrators will not accept the argument that the amount of the attorneys' fee awards should be based upon the contingent fee due, in the alternative, we should argue that the award based upon the attorneys' time and hourly rate should be subject to a risk multiplier. The Florida appellate courts on two separate occasions have approved, without discussion, the use of a 2.5 multiplier in securities cases.[23] Recently, PIABA member Mark Tepper, Fort Lauderdale, received 2.5 multiplier award from a Florida trial court in a securities arbitration. That case is presently on appeal.

Pre- and Post-Judgment Interest

The last area we need to examine as to whether the state arbitration act or the FAA should be elected as the rules of decision is in the area of pre- and post-judgment interest. The first thing is to understand exactly what we are dealing with. In the case of pre-judgment interest, we are not talking about the award by the arbitrators of pre-award interest. Instead we are talking about the award of interest after the award has been entered until the confirming court enters its judgment on the award. Post-judgment interest, then, is interest on the court judgment, through any appeal, until the judgment is paid.

Section 41(h) of NASD Code of Arbitration Procedure controls this issue[24] and states that interest will run on the award[25] from the date of the award until paid.[26] "The arbitration award itself resulted in a new fixed liability [Citation omitted]. Regardless of the individual elements that comprised that liability, respondents were entitled to payment of the fixed sum upon issuance of the award.

An award shall bear interest from the date of award: (1) if not paid within thirty (30) days or receipt, (ii) if the award is the subject of a motion to vacate which is denied, or (iii) as specified by the arbitrator(s) in the award. NASD Manual ¶3741 (1994).

The Rules also provide that: "Interest shall be assessed at the legal rate,[27] Case law indicates that the "contract" legal rate is not the appropriate "legal rate" to be applied in arbitration confirmation cases. See e.g., Boston Children's Heart Found. Inc. v. Nadal-Ginard, 73 F.3d 429 (1st Cir. 1996); Hansen v. Continental Ins. Co., 940 F.2d 971 (5th Cir. 1991); Cant v. A.G. Becker & Co., 379 F. Supp. 972 (N.D.Ill. 1974). This leaves either the "judgment" rate or the securities act rate.

The author thinks the securities act rate is the better choice. It is a special interest statute which runs "from the date of payment" of the initial consideration. Using this rate makes the interest uniform both as to both pre- and post-judgment. if any, then prevailing in the state where the award was rendered."[28]

However, Section 41(h) is silent on one very important issue.[29] Is the interest granted thereunder to be simple interest or compound interest? Stovall v. Illinois Central Gulf R.R. Co.,[30] indicates that this issue will be determined by the appropriate post-judgment interest statute. But which post-judgment interest statute, federal or state?

Under most state laws, interest either pre- or post-judgment is calculated on the basis of simple interest. On the other hand, the federal statute provides in pertinent part:

> (a) Interest shall be allowed on any money judgment in a civil case....
> (b) Interest shall be computed daily to the date of payment..., and shall be compounded annually.[31]

Section 1961(b) clearly provides for the compounding of post-judgment interest.[32] Further, it is clear that both the awarding of interest and compounding it are mandatory.[33]

The author believes that the federal rather than the state statute should control if the arbitration is brought under the FAA.[34] This conclusion applies whether the confirmation action is filed in either federal or <u>state</u> court.

As Parsons & Whittemore Ala. Mach. and Serv. Corp.,[35] held Section 1961 applies to FAA cases by virtue of Section 13 of the Arbitration Act.[36] The judgment so entered [confirming an arbitration award] shall have the same force and effect, in all respects, as, and be subject to all provisions of law relating to, a judgment in an action; and it may be enforced as if it had been rendered in an action in the court in which it is entered. 9 U.S.C. §13. Therefore, it is clear that if the confirmation proceedings are brought in federal court. Section 1961(b) will apply and both pre- and post-judgment interest will be compounded annually.[37] Logic suggests there should be no difference in resultwhether the confirmation proceeding is brought in a state or federal court. In both cases, the FAA controls the confirmation proceedings, and, under Parsons, this means Section 1961(b) applies.

CONCLUSION

From the above discussion, it is apparent that we as plaintiff's counsel need to make a conscious decision whether we want to arbitrate our case under the state or federal arbitration acts. Unfortunately, too often no thought is given to this matter, and we merely assume that the state act controls. Such is usually not the case. Further, in many cases, the FAA gives us a more favorable result.

ENDNOTES

[1] The author would like to thank PIABA member Christopher T. Vernon, Naples, Fla., for pointing out on inaccuracy in the March article. The Uniform Submission Agreement does not contain the question as to which law is the arbitration to take place under. This question is asked in the Claim Form itself. Sorry for the mistake. If other members find similar mistakes, please let the author know and we will try to set the record straight.

[2] Note, however, an argument can be made that the American rule on attorneys' fees applies only in court and does not apply in arbitration.

[3] Tennessee Dep't of Human Servs. v. United States Dep't of Educ., 979 F.2d 1162, 1169 (6th Cir. 1992): Thomas v. Prudential Sec. Inc., 921 S.W.2d 847 (Tex. App. 1996).

[4] In some cases, courts have allowed recovery of attorneys' fees on the proof of either common law fraud or breach of fiduciary duty.

[5] There is a limited recovery provision under §11(e) of the Securities Act of 1933, 15 U.S.C. §77k(e).

[6] Also it has been held that recovery under the Uniform Act can be had for time spent presenting other claims, including federal securities act claims where there is no specific authority to award such fees. See e.g., Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984). Further, recovery can be had for attorneys' fee expended in court proceedings before the case is referred to arbitration. Rauscher Pierce Refsnes, Inc. v. Flatt, 670 So.2d 537 (La. App. 1996).

[7] See, e.g., Davis v. Prudential Sec. Inc., 59 F.3d 1186 (11th Cir. 1995); Robbins v. Painwebber, Inc., 761 F. Supp. 773 (N.D. Ala. 1991); Kelsey v. Nagy, 410 N.E.2d 1333 (Ind. App. 1980); Criticare Systems, Inc. v. Sentek, Inc., 159 Wis. 2d 639, 465 N.W.2d 509 (App. 1990), rev. den., 471 N.W.2d 509.

[8] See, e.g., In re Merrill, Lynch, Pierce, Fenner & Smith, Inc. and Morris, 162 Misc.2d 245, 616 N.Y.S.2d 857 (Sup. Ct.). However, in a new opinion, CS First Boston Corp. v. Schuman, N.Y.L.J. 28, Col. 5 (Supt. Ct., N.Y. County, Feb. 10, 1997), the court held that the Uniform Submission Agreement was sufficient to give the arbitrator's the power to award attorneys' fees. The case further indicates that a broker's membership in a self-regulatory organization such as the NYSE with its requirement to comply with the Exchange's regulations may also be sufficient. See also Neuberger & Berman v. Donaldson, Lufkin & Jenrette Sec. Corp., Index No. 16833/91 (N.Y. Sup. Ct., N.Y. County, 1992).

Earlier, the court in Berman v. Stratton Oakmont, N.Y.L.J. 34, Col. 4 (Sup. Ct., Nassau County, Oct. 18, 1996) held that award of attorneys' fees to plaintiff was permissible where the defendant had requested such fees in its answer.

These cases would seem to bring the New York law in line with the holdings under the federal act. To the extent that New York law differs from that under the FAA, the New York statute is, of course pre-empted. See Fleet Enterprises, Inc. v. Velinsky, N.Y.L.J. 27, Col. 1 (Sup. Ct., N.Y. County, Jan. 29, 1997); R.C. Layne Const., Inc. v. Stratton Oakmont, Inc., 228 A.D.2d 45, 651 N.Y.S.2d 973 (A.D. 1996).

[9] See e.g., Lybrand v. Merrill, Lynch, Pierce, Fenner, & Smith, Inc., 321 S.C. 70, 467 S.E.2d 745 (App. 1996).

[10] The Uniform Act provision has been interpreted differently as to whether after arbitration is complete a winning claimant may seek recovery of such fees from the court. North Carolina and

Arizona take the position that attorneys' fees are improper in arbitration and a court can not award them after the fact. Florida, on the other hand, takes the position that the courts, but not the arbitrators, can make such an award.

[11] This has been done under a number of different theories. Prudential-Bache Sec. Inc. v. Tanner, 72 F.3d 234 (1st Cir. 1995) held that NYSE Rule 629© authorized the awarding of attorney fees as "other costs and expenses". Tanner. Executone Info. Sys. v. Davis, 26 F.3d 1314, 1323 (5th Cir. 1994), and First Int'l Equity Corp. v. Houghton, 842 F. Supp. 104, 112 (S.D.N.Y. 1994) also hold that the submission of the parties claiming attorneys' fees is sufficient. Wing v. Bradford, 678 F. Supp. 622 (N.D. Miss. 1987) holds that the Uniform Submission Agreement itself was sufficient. See also Kamakazi Music Corp. v. Robbins Music Corp., 684 F.2d 228, 231 (2d Cir. 1982); Spector v. Torenber, 852 F. Supp. 201, 210 (S.D.N.Y. 1994). The same result was reached at the state level in Thomas v. Prudential Sec. Inc., 921 S.W.2d 847 (Tex. App. 1996).

[12] Cerajewski v. Kunkle, 285 Ill. App.3d 222, 674 N.E.2d 57, 220 Ill. Dec. 786 (1996); Pinnacle Group, Inc. v. Shrader, 105 N.C. App. 168, 412 S.E.2d 117 (1992).

[13] Davis v. Prudential Sec. Inc., 59 F.3d 1186 (11th Cir. 1995); Prudential Sec. Inc. v. Creedon, 1995 WL 21954, 52 F.3d 334 (table case) (9th Cir. 1995); Rostad & Rostad Corp. v. Investment Mgt. & Research Inc., 923 F.2d 694 (9th Cir. 1991).

[14] 17 F.3d 1007 (7th Cir. 1994)

[15] Id. at 1009. See also Schlobohm v. Pepperidge Farm, Inc., 806 F.2d 578 (5th Cir. 1986). The court in Menke went on to say:

> Thus, in confirming Menke's award, the district court was not free to consider whether an additional award of attorneys' fees would be appropriate. Had it done so, the district court according to Schlobohm, would have essentially made an unwarranted modification of the arbitrators' award inconsistent with its limited review under the Federal Arbitration Act. Therefore, we conclude that the district court was correct in not adding into its confirmation judgment any additional attorneys' fees Menke incurred in bringing this action. 17 F.3d at 1010.

[16] Slinkard v. Ameritas Investment Corp., Case Number 83,376 (Okla. Ct. App. Oct 31, 1995)(unreported).

[17] 473 U.S. 614, 628 (1985).

[18] Slinkard v. Ameritas Investment Corp., Case Number 83,376 (Okla. Ct. App. Oct 31, 1995).

[19] Cf. Raymond, James & Assoc., Inc. v. Wieneke, 591 So.2d 956 (Fla. App. 1991).

[20] This raises the question of whether the arbitrators can delegate their authority to make this determination to the court. Apparently it can. Cf. Smith v. Prudential Sec. Inc., 846 F. supp. 978 (M.D. Fla. 1994).

[21] The arbitrators are not limited by the amount of attorneys' fees set out in the original claim. Bradley v. Hullander,277 S.C. 327, 287 S.E.2d 140 (1982).

[22] See e.g., City Consumer Serv., Inc. v. Horne, 631 F. Supp. 1050 (D. Utah 1986); Raymond, James & Assoc., Inc. v. Wieneke, 591 So.2d 956 (Fla. App. 1991); Jacobs v. James, 215 Ill. App.3d 499, 574 N.E.2d 1292, 158 Ill. Dec. 899 (1991); Gowdy v. Richter, 20 Ill. App.3d 514, 314 N.E.2d 549 (1974); Bradley v. Hullander, 277 S.C. 327, 287 S.E.2d 140 (1982).

[23] Dean Witter Reynolds, Inc. v. Wood, 676 So.2d 464 (Fla. App. 1996); Raymond, James & Assoc., Inc. v. Wieneke, 591 So.2d 956 (Fla. App. 1991). See also Lane v. Head, 566 So.2d 508 (Fla. 1990).

[24] Hayne, Miller & Farni, Inc. v. Flume, 888 F. Supp. 949 (E.D.Wis. 1995); Prudential Sec., Inc. v. Shaifer, 1994 U.S. Dist. LEXIS 7325 (E.D.Pa. May 27, 1994); FSC Sec. Corp. v. Freel, 811 F. Supp. 439 (D.Minn. 1993); Roubik v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 285 Ill.App.3d 217, 674 N.E.2d 35, 220 Ill. Dec. 764 (1996).

[25] *This is the entire award*, including interest, punitive

damages, and attorneys' fees. As the court said in Britz, Inc. v. Alfa-Laval Food & Dairy Co., 34 Cal. App.4th 1085, 1107, 40 Cal. Rptr.2d 700, 713-714 (1995):

> "The arbitration award itself resulted in a new fixed liability [Citation omitted]. Regardless of the individual elements that comprised that liability, respondents were entitled to payment of fixed sum upon issuance of the award.

[26] Section 41(h) provides, in part:

An award shall bear interest from the date of award: (i) if not paid within thirty (30) days of receipt, (ii) if the award is the subject of a motion to vacate which is denied, or (iii) as specified by the arbitrator(s) in the award.
NASD Manual ¶3741 (1994).

[27] [Author's note.] This language is ambiguous. In most states there are three statutes which could apply. There is the *contract legal interest rate* which is used when the contract does not provide otherwise. See e.g., 15 O.S. (1991) §266 setting a general legal rate of six percent. There is the "judgment" legal rate. See e.g., 12 O.S. (1991) §727. This rate like 1961(b) varies from year to year. Finally, there is the rate prescribed in Section 410 of the Uniform Securities Act. The Uniform Act sets this at six percent. However, some states such as Oklahoma have changed this rate. 1 Okla. Stat. (1991) §410 sets the rate at 10 percent.

[28] Id. It also provides that a different rate may be set by the arbitrators.

[29] Stovall v. Illinois Central Gulf R.R. Co., 722 F.2d 190 (5th Cir. 1984).

[30] 722 F.2d 190 (5th Cir. 1984).

[31] 28 U.S.C. §1961. Emphasis added.

[32] In re the Department of Energy Stripper Well Exemption Litigation, 821 F. Supp. 1432 (D.Kan. 1993).

[33] Parsons & Whittemore Ala. Mach. and Serv. Corp., supra; Blanche (Singapore) PTE., Ltd. v. Carte Blanche Int'l, Ltd., 888 F.2d 260 (9th Cir. 1989); Akermanis v. Sea-Land Serv., Inc., 521 F. Supp. 44, 57 (S.D.N.Y. 1981), rev'd on other grounds, 688 F.2d 898 (2d Cir. 1982), cert. denied, 461 U.S. 927 (1983).

[34] Such case is governed by federal rather than state law. Sun Ship, Inc. v. Matson Navigation Co., 723 F.2d 59, 63 (3d Cir. 1986) See also Kanuth v. Prescott, Ball, Turben, Inc., 1990 WL 179601 (D.C. Cir. 1990)(not officially reported). If there is a conflict between federal and state law, then state law is pre-empted.

[35] 744 F.2d 1482 (11th Cir. 1984). See also Stroh Container Co. v. Delphi Ind., Inc., 783 F.2d 743, 751 (8th Cir. 1985) (trial court held federal law controls post-award interest under the FAA. The parties and the appellate court did not dispute this finding on appeal).

[36] 9 U.S.C. §13. See also Northrop Corp. v. Triad Int'l Marketing, S.A., 842 F.2d 1154 (9th Cir. 1987). Section 13 reads:

> The judgment so entered [confirming an arbitration award] shall have the same force and effect, in all respects, as, and be subject to all provisions of law relating to, a judgment in an action; and it may be enforced as if it had been rendered in an action in the court in which it is entered. 9 U.S.C. §13.

[37] Section 1961(b) has also been held to control to pre-judgment interest. In the case of a confirmation proceedings, the pre-judgment interest refers only to interest from the date of the award to date of confirmation.

REPORT FROM NEW YORK

Seth Lipner, DEUTSCH & LIPNER, Garden City, NY

New York is in the throes of a major review of the interplay between its arbitration law and the Federal Arbitration Act. Consider the last year (or so):

1. The 2nd Circuit rules that, under the FAA, eligibility is for the arbitrators because of the "all disputes" clause and First Options, and it rel-

egates the New York choice of law to the substantive issues; Bybyk

2. The Appellate Division First Dept. rules (for the first time) that if there is either (a) no pre-dispute arbitration agreement or (b) the agreement does not contain a Luckie-type choice-of-law provision ("and its enforcement"), all timeliness questions, including eligibility, are for the arbitrators. See Smith Barney v. Hause; Smith Barney v. Sacharow (both discussed infra); Goldberg v. Parker (discussed in previous issues); and
3. A federal District Court judge in New York rules that, under the FAA, if there is no pre-dispute arbitration agreement, a customer demanding arbitration at the AMEX gets a judicial determination of the eligibility issue. Kidder Peabody v. Marriner.

These developments represent some major changes in the law, but, for the practitioner, they require that Claimant's counsel re-think the "removal to federal court" approach to eligibility problems.

Undoubtedly, the most significant decisions this quarter are in Hause and Sacharow. The Appellate Division, First Dept. followed the Second Circuit's Bybyk lead and ruled that, under First Options, eligibility is for the arbitrators. The court distinguished its prior holdings in DeChaine and Manhard on the ground that those cases had a Luckie-type New York choice-of-law clause. The decisions are a positive development for investors and arbitration, but the distinction of DeChaine and Manhard about the New York choice is analytically weak.

As you might imagine, our old adversary, Larry Fenster, seized on that weakness in his application to the New York Court of Appeals for leave to go up (now pending). We don't disagree - we think DeChaine and Manhard were wrong from the start, and that First Options proved it. We also can't disagree with his claim that the issues raised in the cases are of great general importance. We'll see. I, personally, would love to go back to the Court of Appeals to tell them they were wrong in Luckie, but I'd rather just go to arbitration. Mrs. Hause is 87 years old. I wanted to include a photo as Exhibit A to our opposition to Fenster's application for leave to appeal. Herb made me take it out.

Even as we wait to see if the Court of Appeals is going to take Hause and Sacharow, we will be going to Albany soon. That's because, believe it or not, the Court of Appeals granted Kidder Peabody's application to appeal from its loss in Sanders/Vogel. In that case, as you'll recall from the last issue, the Appellate Division said that the AMEX eligibility rule did not apply (at all) to an AMEX-Window arbitration. They agreed with Justice Solomon that Kidder Peabody's assertion was contravened by the plain language of the AMEX Constitution. We (meaning us and KP's attorney) we shocked the Court of Appeals took it. Briefing will take place this summer; argument will probably be in January. We'll have to wait and see. This is one, however, where I hope they don't say "leave it to the arbs" - we won this one in court, so we want it to stay there (uh-oh, I'm starting to sound like them).

On a slightly different front (punitives), the First Department recently ruled that the Mulder case (allowing punitive damages) did not announce a new rule of law (tell that to Mr. Kent, Ms. Garrity and Justice Solomon), and thus it was retroactive. Good news - New York will keep its hands off your punitive awards, whenever they were issued. Keep an eye on Albany, though. That case is Americorp v. Sager.

Pay close attention to another interesting New York decision (called to our attention by Joel Goodman). In Monisoff v. American Eagle Investments, 927 F.Supp. 137 (SDNY 1996), Judge Rakoff narrowly construed a clearing firm's customer agreement to not apply to a dispute between the customer

and the introducing broker-dealer (and its principal). The agreement was far more narrow than some we've seen, thus giving the court latitude, but it is nevertheless something to think about before you demand arbitration in say, a big penny stock case against a thinly-capitalized b-d. If you are going to name a "controlling person" and make (timely) federal claims, you may want to be in court against the b-d and its boss. You'll get more discovery, and we all know arbs don't like to hold individuals personally liable. Food for thought.

See you in October!!!

NASAA Crackdown on Securities Fraud Over the Phone

The North American Securities Administrators Association (NASAA) task force investigation has lead to the filing by twenty state securities commissioners of thirty-six actions against fourteen brokerage firms.

The targeted firms include Investors Associates, First United Equities, Nationawide Securiteis, Kensington Wells, LT Lawrence, Toluca Pacific, Meyers Pollack, Capital Securities/WB McKee, State Capital Markets, Sterling Foster, Biltmore Securities, William Scott & Co., and Euro-Atlantic.

For additional information contact NASAA at (202) 737-0900 or the NASAA website at www:nasaa.org.

The Use Of Securities And Exchange Commission Decisions As Precedent In Arbitration Proceedings

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This is the first of a two part Article, the second part of which will appear in the September issue of the Quarterly.

INTRODUCTION

Attorneys representing parties in arbitration proceedings are being increasingly asked by arbitration panels to produce concise case citations to support their clients' positions in securities arbitration proceedings. Unlike belabored briefs which might be required in a securities fraud case venued in Federal Court, many arbitrators are simply looking for one or two cases to support an award which might be made in any given case that can be supported by viable case law. The demands made by arbitrators upon counsel in securities arbitration proceedings for the production of legal briefs and citation to applicable case law can run a range from the provision of a single photocopy of a case to a demand for a brief along federal court guidelines with a table of contents, list of authorities, footnotes and appendices. Decisions of the Securities and Exchange Commission offer guidance to the practitioner on virtually any issue involving supervisory red flags.

In the Matter of Royal Alliance Associates, Inc., 1997 SEC Lexis 113 at page 14 (1/15/97), the Commissioner noted that:

> [m]any failure-to-supervise cases involved indicators of misconduct, or "red flags", that should have immediately alerted management to potential wrong doing...[i]n circumstances where a firm's compliance and supervision system is inadequate to discover the indications of problema' conduct, the personal responsibility fo supervision cannot be fulfilled by a supervisor who is simply unaware of the indicators.

This article addresses one dozen separate "red flags" which commonly arise in customer-broker/dealer disputes and the manner in which administrative decisions of the Securities and Exchange Commission have dealt with circumstances where these "red flags" have been raised. In the Matter of Arthur James Huff, Admin. Proc. File No. 3-6700, Securities Exchange Act of 1934, 1987 SEC Lexis 3013 at pages 9-10 (12/15/87), it was noted that "...a branch manager is the first line of defense when it comes to supervision of registered representatives and endeavoring to assure their compliance with applicable laws and regulations".

As more and more customer claims are resolved in Arbitration proceedings versus court venued proceedings, there is less new case law being made addressing the obligation of a brokerage firm to the investing public. Further, when arbitrators seek case law guidance on damages issues many of the court venued cases cited are cases which are 10b-5 damages based on prospectus fraud, insider trading market theory damages. Some arbitrators do not even want to be provided with any case authority and expressly state so on the record in arbitration proceedings. Further, this author suggests that the private Securities Reform Act of 1995 will have a chilling effect on the various District Courts and various Federal Circuit Courts of Appeal as being the source of well articulated decisional law protecting the rights of small investors filing claims under the Federal Securities Laws. A significant exception, however, would be the decision of the United States District Court for the Northern District of New York in Capital District Physicians Health Plan v. O'Higgins, 939 F. Supp. 992 (N.D.N.Y. 1996) motion for reconsideration denied 951 F. Supp. 352 (N.D.N.Y. 1997). This represents a decision which will afford Arbitration Panels many insights particularly on issues of common law theories of recovery, ratification and damages. (See Appendix A).

Establishing the duty of a branch manager to provide proper supervision of his or her brokers is often an essential part of any claimant's case. The question often arises in arbitration proceedings as to just how far must a branch manager go towards assuring the proper supervision of a broker. Although Rule 3010 of the NASD Manual Conduct Rules (formerly Section 27 of the NASD Rules of Fair Practice) and the Rules of the New York Stock Exchange set forth general rules of supervision they do not fully articulate the specifics of just what is required of a branch manager when supervising a broker engaging in questionable activity. Further, most State and Federal cases which touch upon issues of supervision fall short of specifying the exact steps which a branch manager should have taken in a certain case in order to have prevented customer victimization.

Many arbitrators lack extensive experience with the securities industry and are not conversant with the job function of a branch manager and are therefore unable to articulate what should have been done in a particular situation. Without any authoritative guidance the question of what the branch manager should or should not have done is often left to a battle of expert witnesses. Decisions of the Securities and Exchange Commission in administrative proceedings can provide a detailed description required of a branch manager in any number of situations. These decisions can be accessed on Lexis or West Law and are also available in most law libraries in hard copy through the Commerce Clearing House Federal Securities Law Reporter or the SEC Docket, the official reporter. A diligent search through these decisions should provide counsel with persuasive if not controlling authority for the steps which a branch manager should have taken to assure that the interests of the customer were being protected at all times.

Many of these administrative decisions speak for the proposition that once a branch manager or compliance officer is on inquiry notice of any possible improprieties he or she then has an obligation to make an independent inquiry of transactions in customer accounts without relying on the representations of the broker. In fact, many of these decisions suggest the simple expedient of branch manager contact with the client by telephone to verify the representations which the broker has made to the branch manager regarding a customer's account. Such a simple step would be particularly helpful in verifying a broker's representations to the branch manager that certain trades in a customer's account were being made on an unsolicited

versus a solicitated basis. A simple phone call by the branch manager to the customer can also serve to verify the accuracy of the net worth, age, employment and investment experience representations on the new account form. Turning a blind eye to questionable account activity can lead to dangerous consequences for the branch manager, branch offices and the firm.

This article addresses the findings of certain administrative decisions of the Securities and Exchange Commission addressing one dozen separate areas of concem or red flags commonly addressed in customer-broker/dealer disputes which articulate the specific obligations of the branch manager in commonly addressed circumstances as follows:

1. The duty of the branch manager to keep proper books and records and to review specific documentation to detect irregularities and proper follow through with activity letters and active accounts.
2. The duty of the branch manager to detect criminal activity.
3. Account activity at variance with customer information on the new account form.
4. Are the trades in the customer's account really unsolicited?
5. Excessive account concentration and trading activity in a single stock.
6. The obligation of supervision of investment advisors under the Investment Advisors Act of 1940.
7. The obligation to supervise financial planners.
8. The duty of supervision extends well beyond the branch office.
9. The duty of the branch manager to meet with the customer in person or to contact the customer by telephone.
10. The duty of the branch manger to detect illegal "cross-selling" and "no net sales practices".
11. The duty to assure that the customer is being provided with proper "break-point" and rights of accumulation information on mutual fund purchases.
12. The duty to assure proper supervision of satellite branches or single broker branch offices.

(I) <u>The duty of the branch manager to keep proper books and records and to review specific documentation to detect irregularities and proper follow through with activity letters and active accounts.</u>

The theory of liability in many arbitration proceedings often hinges on a determination as to the specific documentation which the branch manager should have reviewed in order to make a showing of proper and adequate supervision of the registered representative. In the <u>Matter of Sandra Logay</u>, Admin. Proc. File no. 3-8969, S.E.C. Securities Exchange Act of 1934, Release No. 36924, 1996 Sec Lexis 584 (3/6/96). The commission determined that the former branch manager of the Chesterfield, Missouri branch of Prudential Securities, Inc., failed to reasonably supervise a registered representative so as to prevent violations of the anti-fraud provisions of the Federal Securities Law by:

> ...failing to adequately review and analyze many documents necessary for reasonable supervision of the registered representative including, but not limited to, such items as customer complaints, new account forms, the registered representatives holding pages outlining the trading in his customer accounts, monthly customer account statements, fund transfer records, customer order tickets, revenue reports, active account reports, commission to equity reports and manager supervision guide or "MSG" reports.

This cook's list of required documentation for review by the branch manager is by no means an exclusive list but the ruling in the <u>Matter of Sandra Logay</u>, supra, articulated the need for the branch manager to make a detailed review of the above itemized documents which are normally required for production by brokerage firms in the discovery phase of arbitrations.

Activity letters, letters prepared by the branch office seeking a customer's acknowledgment of excessive trading activity or losses in his or her account, and the manner in which they are prepared, delivered to the client and received back by the firm often provide numerous "red flags" to the branch manager. Once accounts have been singled out for activity letters, common sense requires that branch managers follow the activity letter from its preparation through its ultimate

receipt from the client in order to detect any irregularities. Indeed, the mere failure to receive a return activity letter has been determined to constitute cause enough for a branch manager to make direct contact with a non-responding customer. In the Matter of Arthur James Huff, 1987 SEC Lexis 3013 (1987) at page 16, the branch manager there was faulted for permitting a wholesale breakdown in the activity letter process as follows:

> Huber (the branch manager) received only nine out of the twelve activity letters that were purportedly sent to Greenman's customers...Huber did not contact the customers who apparently failed to respond...[s]uch contacts by Huber were particularly called for here since Huber had allowed Greenman (the broker) to send out the letters himself rather than following the suggested practice of having a branch manager send them out.

The decision went on to note that the broker there succeeded in preparing another set of activity letters, sent to pre-arranged post office boxes, to which he had forged his customers signatures.

In the Matter of Prudential Securities, Inc., Admin. Proc. File No. 3-8209, Securities Exchange Act of 1934, Release No. 33082, 1993 SEC Lexis 2866 (10/21/93), involved an order of the Securities and Exchange Commission with a determination of lax supervisory practices on the part of Prudential Securities which dealt with, inter alia, the failure of branch office managers to follow through with active account reports. In faulting, Prudential, the decision noted that:

> [m]any customers were not contacted by branch offices managers, even though their accounts repeatedly appeared on active account reports...[i]n virtually all cases, meaningful contact could have detected and prevented violations...PSI experienced a serious breakdown in its active account review procedure (1993 SEC Lexis 2866 at page 64)

The simple expedient of client contact by the branch manager, it was determined, would have prevented trading improprieties being engaged in by brokers in branch offices.

(ii) The duty of the branch manager to detect criminal activity.

Many arbitration claims involve instances of a broker theft involving customer checks or securities. Such claims are often met with the defense that a firm is not liable for the criminal acts of its registered representative acting outside the scope of employment. Broker theft of customer monies, however, is a recurrent problem and a problem which often can be prevented through proper supervisory practices.

In the Matter of Charles Schwab & Co., Inc., Admin. Proc File No. 3-6222, SEC 1983 SEC Lexis 2821 (12/28/83), dealt with a fact pattern involving a ponzi scheme perpetrated by a broker who deposited over $342,000.00 worth of investor checks into her personal securities account at Charles Schwab. The Administrative Law Judge had determined that the branch manager exercised inadequate supervision with respect to third-party-check procedures and the training of cashiers at the branch office in question. The decision also determined that the branch manager failed to make a proper investigation of the broker after becoming aware of the broker's "clearly erratic behavior", particularly as related to the broker's personal adverse financial circumstances. (Matter of Charles Schwab & Co., Inc., supra, 1983 SEC Lexis 2821 at pages 35-36. This decision also cited supervisory shortcomings which involved the failure of the office cashier to obtain a release from specified customers who had purportedly deposited cashier checks with their names noted on the face of the cashier checks which were deposited into the account of the broker, as such releases are required by industry practice. 1983 SEC Lexis 2821 at pages 13-14.

In the Matter of Robert Hoffman, Walston & Co., Inc., et al, Admin. Proc. File No. 3-3492 SEC, 1974 SEC Lexis 3630 (6/28/74), involved the supervisory failings of a branch manager who permitted a registered representative to remain in the office as a broker well after the discovery of the fact that the

broker had lied about his educational experience and financial history which, it was determined, "...should have warned the respondents of his propensity to lie when he felt it was necessary and that respondents should have exercised special care in his supervision." 1974 SEC Lexis 3630 at page 11. The broker was determined to have engaged in numerous unauthorized trades in customer accounts as well as having converted customer funds for his own use, as well as having made numerous unauthorized withdrawals of monies from various customer accounts. Despite numerous customer complaints, the branch manager failed to engage in close supervision over the broker and failed to make direct contacts with the customers. The broker there explained away a number of questionable trades in various customer accounts as "trade adjustments" to which proper inquiry was also not made. Ultimately, the decision of the Administrative Law Judge agreed with the contentions of the Division that the broker/dealer "did not have supervisory procedures requiring confirmation by direct contact with customers when matters indicating this conduct by account executives were revealed...nor was there any system for following up with the customer to determine whether there were special problems requiring supervisory intervention", 1974 SEC Lexis 3630 at page 30-31.

The decision in the Matter of Robert Hoffman, Walston & Co., Inc., et al, supra, went on to note at 1974 SEC Lexis 3630 at pages 37-38 that:

> While Hoffman was obviously not authorized to engage in criminal activities and other violations of the Securities Act and the Exchange Act, the doctrine of respondeat superior still applies to his activities and the Registrant is responsible for the violations committed by him while he was in Registrant's employ. These violations were willful within the meaning of the Exchange Act (citing Sutro Bros. & Co., 41 S.E.C. 470 (1973) and Tager v. S.E.C., 344F 2d 5, 8 (2nd Cir. 1965), affirming, Sidney Tager, Sec. Exch. Act Rel. No. 7368 (7/14/64); accord Harry Marks, 25 S.E.C. 208, 220 (1947); George W. Chilian, 37 S.E.C. 384 (1956); E.W. Hughes & Co., 27 S.E.C. 629 (1948); Hughes v. S.E.C. 174 F 2d 969 (C.A. D. C. 1949); Shuck & Co., 38 S.E.C. 69 (1957); Carl M. Lobe Rhoades & Co., 38 S.E.C. 843 (1959); Ira Haupt & Co., 23 S.E. C. 589, 606 (1946).

Another branch manager supervisory failing which enables a broker to engage in criminal activity involves the use of post office boxes. This scenario was addressed in the Matter of Arthur James Huff, 1987 SEC Lexis 3013, which addressed the supervisory failings within a branch office and compliance department which permitted a broker to engage in a complex scheme to defraud by using post office box numbers as mailing addresses for the various victims of this scheme. The decision noted that "...Huber (the branch manager) did not do anything to verify independently any of Greenman's explanations for the similar addresses on his customer accounts either then or later, when additional information raising questions about Greenman's option trading program came to Huber's attention", 1987 SEC Lexis 3013 at page 12. In the same case, the Senior Registered Options Principal in the Compliance Department was also faulted for failing to make further inquiry despite the fact that he acknowledged that the use of post offices boxes as customer addresses was a "red flag", noting that "...he did not attempt to obtain a home or business address for any of those customer accounts", 1987 Sec Lexis 3013 at page 41.

(iii) Account trading activity at variance with customer information on the new account form - Matter of Prudential Securities.

When trades in a customer's account exceed the stated assets in a customer account agreement, the branch manager has a duty to intervene and make a thorough inquiry. In Matter of Prudential Securities, 34 SEC Docket 1094, 1986 W.L. 72873 at page 76, the Securities and Exchange Commission noted that ". . . in two instances where information contained in the customer's option agreement was accurate, Kalil (the broker) told Solomon (the branch manager) that the customers had greater assets than the customers disclosed in their options agreements in order to justify excessive trading for

these accounts . . . based upon Kalil's representations, Solomon permitted options trading in these accounts to continue".

In holding Prudential responsible, the Commission cited authority for holding branch managers responsible for failure of supervision in instances where they "...relied solely upon representations made by the account executive in response to inquiries concerning certain trading". See Bache Halsey Stuart Shields, Inc., et al., SEC 1934 Docket Release No. 19725 (May 3, 1983). In the case of the Matter of the Application of Bradford John Titus, 63 SEC Docket 926, 1996 W.L. 705335 (S.E.C.), the Securities and Exchange Commission addressed a situation wherein a broker told his superiors that trades made in an elderly customer's account were in fact approved by her, when in fact, they were not and further, despite the fact that the broker there made trades well in excess of the client's stated financial resources, the broker told his supervisors that his client had greater financial resources than were previously disclosed in her new account form. In making a determination that the brokerage firm had violated Article III, Sections 1 and 27 of the NASD Manual Rules of Fair Practice, the commission noted that:

> Where there are ample indications of irregularities and misconduct by a registered representative, such as are displayed here, we have held that it is "especially imperative" that those in authority "exercise particular vigilance" over the registered representative (citing Wedbush Securities, Inc. , 48 S.E.C. 963 (1988).

(iv) Are the trades in the customer's account really unsolicited?

Branch managers have a duty to make independent inquiry when a broker insists that excessive activity in a customers account is unsolicited when the nature of the trading activity appears otherwise. In the Matter of First Albany Corporation, 51 SEC Docket 87, 50 SEC 890, Release No. 34-30515, 1992 W.L. 64040 (SEC), the Securities and Exchange Commission addressed the supervisory failures of the Boston Offices of First Albany Corporation involving a registered representative who accumulated concentrated positions in a speculative security. The broker there advised his branch manager that his trading of hundreds of thousands of shares of this stock in numerous customer accounts was unsolicited. In faulting the branch manager for failing to conduct any inquiry to determine whether the registered representative's purchases in the stock were in fact solicited transactions, it was determined that the branch manager "failed reasonably to supervise the registered representative by failing to respond reasonably to recognized indications of wrongdoing".

Further, the SEC faulted First Albany's Chief Compliance Officer noting that he:

> ...accepted the registered representative's statement that all the trades were unsolicited without performing any further inquiry. The volume of the trading (more than 100 trades) over a three month period, however, necessitated further inquiry. thereby failing to prevent violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and 10-5 thereunder.

It has been also held that compliance department personnel such as a Senior Registered Options Principal responsible for oversight and supervision of a branch office and a branch manager also have a responsibility to make inquiry as to whether or not, in certain circumstances, trading activity is in fact "unsolicited" when trading activity tends to indicate otherwise. In

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the Matter of Arthur James Huff, Admin. Proc. File No. 3-6700, Securities Exchange Act of 1934, 1987 SEC Lexis 3013 at page 42 (12/15/87), the Senior Registered Options Principal in the compliance department was faulted for failing to make inquiry regarding a brokerage claim that certain orders were, in fact, unsolicited. The decision noted that:

> [a]lthough Greenman (the broker) told Huff (the SROP in the compliance department) the orders were unsolicited, they were in fact "discretionary" orders although, as previously noted herein, proper authorization for discretionary trading had not been obtained...Huff should have known or strongly suspected this since the nature of Greenman's program, as Huff understood it from the Paine memorandum and otherwise, was such that Greenman suggested trades to customers...Huff acted as if he were reluctant to turn over a stone of suspicion for fear of what might turn up underneath.

This decision amply points out that branch managers and compliance personnel cannot rely solely on the representations of the broker regarding the nature of solicitation of trades.

The false marking of order tickets as unsolicited when they are in fact solicited has been held to constitute a violation of the Federal Securities Laws. See in the Matter of Wall Street West, Inc., et al, Admin. Proc. File No. 3-6119; 8-22329; 8-7303, 1983 Sec Lexis 2822 at page 48, aff'd 718 F2 973 (10th Cir 1983), citing Haight & Co., Inc., et al., 44 S.E.C. 481 (1971), wherein the Commission noted that: "...we think it is clear that the use of the term "unsolicited" where the order was in fact solicited constituted a false entry which could hamper this Commission in its investigatory functions".

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