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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

September 2000 Volume 7 Number 3

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The

PIABA

Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

September 2000

Volume 7, Number 3

Editor's Notes

This issue of the Quarterly departs from our usual format.

This issue provides a practitioner's guide to some of the problems encountered in the arbitration process.

The deadline for receiving submissions for the June, 2000 issue of the *Quarterly* is June 10, 2000. All submissions, regardless of length, should be accompanied by a computer disk of the submitted materials in either word perfect or as a text file.

Please send change of address information to Robin Ringo at 2241 W. Lindsey St, Ste. 500, Norman, OK 73072. Toll Free: (888) 621-7484; Fax: (405) 360-2063; E-Mail: ***rsringo@piaba.org***; Website: ***www.piaba.org***.

President's Letter

Mark E. Maddox, MADDOX KOELLER HARGETT & CARUSO

Dear Members:

I'm sitting here composing my last President's letter to the membership. Again. This time I really mean it! I'm convinced that if PIABA can survive the last year, as difficult as it was, we can survive anything. It may be a cliche, but that which doesn't kill us makes us stronger. PIABA is much stronger after enduring this past year.

I want to use the balance of this article to thank those who make PIABA so great and are rarely thanked enough. Robin Ringo remains one of my favorite people in this entire world, and we are so lucky to have her. Thanks to Joe Long for offering her services to us about 4 years ago.

The PIABA Board does so much for us that most members never see. Thank you all or your time, commitment, and friendship. Bill Lapp and Diane

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Nygaard will be particularly missed as they retire from the Board this Fall. Bill and Diane were great directors and even better people.

I must also thank all those members who devoted time to PIABA committees, as you did a terrific job. PIABA is doing some of its most important work through our committees, and they remain one of the best places for members to get more involved in the Association.

If you subscribe to Seth's theory that PIABA primarily exists in cyberspace, then I would be remiss not to thank all members who help others so selflessly through the list-serve. Tom Mason warrants special thanks. I think we continue to be unique in our willingness to share information and truly help our colleagues. Not many lawyers are capable of this cooperation.

Finally, I want to thank the entire organization for all the support you've offered to me over the last 2 years. I know I couldn't have done it without your support. It has been a tremendous honor for me to serve PIABA 2 times as its president. I look forward to watching this organization realize its full potential and fulfill its destiny.

Mark E. Maddox, PIABA President

RESPONSE TO NETTING OF GAINS-LOSSES

Martin H. Aussenberg, Esq.
Memphis, TN

[Editor's Note: This is a portion of a brief submitted by Mr. Aussenberg which has been edited for inclusion in this publication.]

As the proof adduced at the hearing will show, the Claimants suffered over $300,000 in damages because of unsuitable transactions effected in their account. Those unsuitable transactions were the result of the Respondents failure to satisfy their duty of assuring that there was a "reasonable basis" for the recommendation (or, in this case the effectuation) of a purchase or sale of a security.

Because the losses incurred were the result of the sales of securities for which the Respondents did not have a "reasonable basis," as they were required to have under all applicable standards, including the Respondent's own policies and procedures, the Respondents may suggest that those losses should be diminished by any profits that were realized in connection with sales of the same security, or of other securities in the Claimants' accounts. This principle is sometimes known as "netting."

The panel in this case is strongly urged to resist any attempt by the Respondents to apply the netting concept, because, among other reasons, courts have consistently held that netting should not be available to the wrongdoer in a securities action. Where, for example, there is a breach of fiduciary duty or a fraud engaged in by a broker, the fact that the investor's overall portfolio was profitable is no defense. In ***Levine, et al. V. Futransky** and **E.F. Hutton Co.***, 636 F. Supp. 899 (N.D. Ill. 1986), the court denied defendants' motion to dismiss on the ground that the plaintiff could not establish any damages since the aggregate earnings in one the portfolios exceeded the aggregate loss in another. The court rejected this argument, holding:

> In *Affiliated Ute Citizens v. United States* [citation omitted], the Court did not determine whether plaintiffs were damaged by netting the aggregate gains and the aggregate losses. Instead, the court held that the correct measure of damages...is the difference between the fair value of what the plaintiff received and the fair value of what the plaintiff would have received had there been no fraudulent conduct.[citation omitted]. In the instant case, this Court holds that Plaintiffs suffered damages even though the investment portfolios incurred a net gain. Plaintiffs may be entitled to recover the difference between the losses incurred on the sale of the speculative securities and the greater amount plaintiffs would have received had they not been defrauded and the greater amount plaintiffs would have received had they not been defrauded and the more conservative securities had been bought and sold.

Levine,[1] 636 F. Supp at 900.

Likewise, in *Nesbit v. McNeil and Black & Company, Inc.*, 896 F.2d 380 (9th Cir. 1990), the court of appeals affirmed the district court's judgment on a jury verdict awarding damages to the customer on its federal securities claims, notwithstanding the fact that the investor's account showed an overall profit. Specifically, the defendants argued that the plaintiff's portfolio gain should be offset against the plaintiff's loss; the court of appeals, disagreeing, stated in relevant part:

> Defendants would have us say that a broker who, for example, engages in unsuitable of the account but actually buys suitable or successful investments cannot be held responsible for his actions. One can easily envision a single successful security which is bought and sold an unreasonable number of times, thereby relieving the client of gains and improperly enriching the broker. We would be remiss if we were to find no redress within the securities law for that kind of wrongdoing.

Nesbit, 896 F.2d at pp. 385-6.

Likewise, in *Davis v. Merrill Lynch*, 906 F.2d 1206 (8th Cir. 1990), the court of appeals affirmed the district court's entry of judgment on a jury verdict awarding damages to the plaintiff based on violations of federal securities laws, common law fraud and breach of fiduciary duty. Refusing to net gains against losses, the court held:

> If we were to adopt Merrill Lynch's view, securities brokers would be free to churn their customers' accounts with impunity so long as the net value of the account did not fall below the amount originally invested.

Davis, 906 F.2d at pp. 1218.

In *Kane v. Shearson Lehman Hutton*, 916 F. 2d 643 (11th Cir. 1990), the customer's claims involved purchases and sales of stock issued by one company. On one trade, the customer made a profit; on another the customer had a loss. Shearson argued the two trades should be netted against one another. The customer claimed that as a matter of policy and statutory construction, Shearson was wrong.

Whether Shearson or the customer was correct turned on the proper interpretation of Florida's securities statute. The statute, which parallels Tennessee's recissionary format,[2] provides:

> (3) In an action for rescission:
>
> (a) A purchaser may recover the consideration paid for the security or investment, plus interest thereon at the legal rate, less the amount of any income received by the purchaser on the security or investment upon tender of the security or investment.

Fla. Sat. §517.211(2)-(4).

The Eleventh Circuit first observed that the remedial goals of the securities laws weighed heavily against Shearson's contentions:

> What is found under both federal and Florida law, is the intent to have securities anti-fraud provisions enforced stringently to deter fraud. [citation omitted]. As the district judge noted, 'If the . . . methodology espoused by [Shearson] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equal prior gains.'
>
> 916 F.2d at 646.

The *Kane* court then turned to the text of the Florida statute and concluded that the language negated any legislative intent to permit netting:

> [T]he plain language of the statute reveals the intent to allow a purchaser fraudulently induced into purchasing a security to rescind his purchase, or, if he has already sold at a loss, to be put by an award of damages in as good a position as if he had rescinded the transaction. There is no indication that other transactions are relevant to this calculation at all.
>
> Id.

Like *Kane*, the court in *In re Clinton Oil Company Securities Litigation*, 1977 U.S. Dist. LEXIS 16787 (D.

Kan. 1977), a case decided under Rule 10b-5 of the Securities Exchange Act of 1934 (one of the bases for the claim in the matter before this panel), analyzed the netting issue in terms of policy and statutory language. Allowing defendants to net profits would undermine Rule 10b-5's remedial purpose by allowing wrongdoers to potentially escape liability:

> [T]he application of such profits as an offset against losses realized in separate, unrelated transactions would be an unwarranted windfall to the wrongdoers.

Id. at *5. The text of Rule 10b-5 also undercut the defendants' contentions. The implication of the Rule's language is that "each fraudulent act by which a person induces another to purchase or sell stock to his detriment creates an actionable wrong." ***Id.*** at *3-4. Therefore, each purchase tainted by a violation of the Rule "results in a separate actionable wrong." ***Id.*** at *4. As a result, "shares obtained in separate and independent purchase transactions should not be offset for the purpose of reaching a net figure." ***Id.*** at *5.

The courts' overwhelming rejection of netting is rooted in the U.S. Supreme Court's decision in ***Randall v. Loftsgaarden***, 478 U.S. 647 (1986). In ***Randall***, the Supreme Court, interpreting the recissionary damages remedy under § 12(2) of the Securities Act of 1933, upheld a defrauded investor's right to a full recovery with no offset for tax benefits the investor received while owning the security. ***Id.*** at 648. The Supreme Court reasoned that, because the federal securities laws serve the dual purpose of deterring fraud and compensating defrauded investors, an investor's recovery "should not be limited to mere 'net economic loss.'" ***Id.***, at 648, 656-661. The Court stated: "rescission. . . adds an additional measure of deterrence as compared to a purely compensatory measure of damages." ***Id.*** The Court acknowledged that the rule against netting potentially puts the purchaser in a "better position than he would have been absent the fraud. . . ." However, as it stated: "[i]t is more appropriate to give the defrauded party the benefit of any windfall. . . ." ***Id.*** at 663 [citation omitted].

Randall is unusually on point, because of the similar language in T.C.A. 48-2-122 and § 12(a)(2). Under § 12(a)(2), an investor is entitled "to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. . . ." 15 U.S.C. §77l(2). Similarly, T.C.A. §48-2-122 provides for recovery of "the consideration paid for the security, together with interest thereon...less the amount of any income received on the security, upon tender of the security . . . ."[3] Given the similarity of language and statutory purpose, ***Randall's*** rejection of netting cannot be distinguished here, and must be rejected.[4] Accordingly, Claimants are entitled to claim losses in their accounts to be adjusted under the "well managed account theory" which cannot be offset by any gains in other transactions or other income or dividends from the accounts.

Courts in at least nine jurisdictions interpreting statutes similar to Florida's, have held netting improper.[5]

The panel's attention is also called to the decision of the arbitration panel in the 1990 American Arbitration Association arbitration of ***Peterzell v. Dean Witter Reynolds, Inc., et al.*** (Case No. 32-136-0416-ID). The decision persuasively encapsulates several principles applicable in the instant proceeding. First is the fiduciary responsibility of the broker. ***Peterzell***, p.2.[6]

> ...the law imposes certain fiduciary duties on brokerages, even where the account is non-discretionary [including] (1) the duty to recommend a security only after sufficiently [sic] informed as to its nature, price, and financial prognosis;..(6) the duty to transact business only after receiving prior authorization from the customer.

Peterzell, op cit.(***citing Leib v. Merrill Lynch***, 461 F. Supp. 951, 953 (E.D.Mich. 1978) and ***Gochnauer v. A.G. Edwards and Sons, Inc.***, 810 F.2d 1042 (11th Cir. 1987).

The panel also found, under the facts presented to it that,

> there was a duty imposed on [the firm] to take adequate steps when it became apparent that *Peterzell* was trading inappropriately, that he was losing large amounts of money and that he was

putting excessive amounts of his net worth at risk, and that,

> While violations of in-house rules do not state a cause of action by themselves [citation omitted, the content of such rules may be used to establish the correct standard of care. ***Thropp v. Bache, Halsey, Stuart, Shields, Inc.***, 650 F.2d 817, 820 (6th Cir. 1981).

Peterzell, at p. 3.

Endnotes

1. This, incidentally, is precisely the relief afforded a defrauded customer under the civil liabilities section of the Tennessee Securities Act as well. T.C.A.§48-2-122.
2. T.C.A. §48-2-122(a)(1)(b).
3. And, like §12(a)(2), the Tennessee Securities Act allows the assessment of "reasonable costs, including reasonable attorneys' fees..."T.C.A. §48-122(f).
4. Likewise, trading losses **should not be offset** by interest income and dividend income under any measure of damages. ***Randall v. Loftsgarden***, 478 U.S. 647 (1986); ***Kane v. Shearson Lehman Hutton***, 916 F.2d 643 (11th Cir. 1990); ***cf. Davis v. Merrill, Lynch, Pierce, Fenner & Smith***, 906 F.2d 1206 (8th Cir. 1990).
5.
   - ***In Re McDowell***, 87 B.R. 554, 560 (S.D. Ill. 1988) (investor who engaged in several separate purchases of unregistered securities sold in violation of Wisconsin's securities statutes had the option of electing to rescind only the unprofitable ones).
   - ***Piantes v. Hayden-Stone, Inc***, 30 Utah 2d 110, 111, 514 P.2d 529, 530 (1973), ***cert. denied***, 415 U.S. 995 (1983) (Utah securities law: netting not required; statute "permits recission of any purchase which the purchaser chooses to make").
   - ***Treider v. Doherty & Co.***, 86 N.M. 735, 737, 527 P.2d 498, 501 (App. 1974) (New Mexico law: securities plaintiff is entitled to void any sale violating securities statute regardless of profit made on other sales.)
   - ***In Re Cannon, III***, 1999 WL 99000 (Bank. W.D. Tenn.) (applying Section 22(a) of the Commodity Exchange Act).
   - ***Crater v. International Resources, Inc.***, 92 Ohio App.3d 18, 25 633 N.E.2d 1212, 1216 (1993) (applying Ohio securities statute).
   - ***Dixon v.Oppenheimer & Co., Inc.***, 739 F.2d 165 (4th Cir. (1984) (Virginia securities law: "the buyer of securities may recover damages for any sale of securities regardless of whether the buyer happened to profit from other sales.")
   - ***Fager v. Nadell***, 1998 WL 226414 *4 (CFTC 1998) (Commodity Exchange Act violations: "To permit such an offset [of profit] would be to reward perpetrators of fraudulent scheme designed to induce customers into investing large sums by an initial profitable transaction.")
6. Claimants have previously cited the 6th Circuit's decision in ***Mansbach v. Prescott, Ball & Turben***, 598 F. 2d 1017, 1026 (6th Cir. 1979) for the same proposition. *Pre-Hearing Memorandum*, at p. 6.

DAMAGES IN FAILURE TO EXECUTE CASE

William Shephard
Shepherd & Smith
Houston, TX

[Editor's Note: This is a portion of a brief submitted by Mr. Shephard which has been edited for inclusion in this publication.)

The rule for determining damages in a case involving investment orders is long standing. The formula determined by courts for improper purchases is "the highest intermediate value of the stock between the time of the execution and a reasonable time **after** the owner received notice of it". ***Galligher v. Jones***, 129 U.S. 193, 200 (1889), ***Reed v. White, Weld & Co., Inc.***, 571 S.W.2d 395, 397 (Tex. Civ. App.--Texarkana 1978, no writ). [The congruent for improperly handled sales orders would be the lowest intermediate value to sell] This rule, often referred to as the "New York Rule" (39 Harv. Law Rev. 124), was specifically designed to calculate damages on fluctuating securities such as Claimant seeks from this

Panel. Damages are based on the lost profit realized within a reasonable time, furthermore it is not even necessary to actually sell at the lower prices. Since the Rule is well established, the issue before this Panel is what is a "reasonable time" period after notice of the problem. Respondent would have you believe that Claimant, not Respondent, who was in a superior position, must take action immediately to cure the situation.

There is no set formula to determine what is a reasonable time. Most courts analyze this on a case-by-case basis and have concluded that, "under varying circumstances findings of 15, 30, or 60 days" have been deemed reasonable periods to cure problems. ***Mayer v. Monzo***, 117 N.E. 948, 950 (N.Y. 1917). The court further stated that damages are based on the highest prices "which have prevailed during such reasonable period." *Id.* The issue would be how much time the Claimant requires to make rational decisions.

There are a variety of questions to be considered by the panel to determine a "reasonable period". The most important question to be determined is what period of time is needed for the owner of the stock to consult persons familiar with the investment business, counsel, and to watch the market for the purpose of determining when, if at all, he should take action in the market. ***Id., Hornblower & Weeks-Hemphill Noyes v. Lazere,*** 222 N.W.2d 799, 807 (Minn. 1974), ***Nye v. Blyth Eastman Dillion & Co., Inc.***, 588 F.2d 1189, 1198 (8th Cir. 1978). The proper reaction for most who are victims of execution and other problems at brokerage firms is that it when the mistake or problem lies with the brokerage firm then the problem or mistake should be fixed by the firm. This was not the case with this Claimant who was stonewalled, with no attempt to mitigate on the part of the firm. All of these factors should be considered by the Panel and, in any event, Claimant cannot be charged with the responsibility to take instant action, according to all known authority.

In fact, this Claimant put Respondent on notice of its failures quite soon and of his position, and it was instead Respondent which chose to ignore the problem, perhaps hoping it would go away. This Claimant then carefully outlined his exact damages at times when these occurred, without any, possibility of speculative 20-20 hindsight. He is actually entitled to the "lowest intermediate value" rather his documented actual non-speculative damages. There can be no doubt of the actual damages which occurred as a result of Respondent's failures to execute his order. Nor can Respondent simply state that Claimant had the obligation to resolve Respondent's failures, or that Claimant should somehow be the one to undertake responsibility for curing the problem. With "reasonableness" as the test, Claimant's actions were entirely reasonable, while those of Respondent were entirely unreasonable.

Furthermore, to find authority for the measure of damages as the lowest intermediate value during a reasonable period of time and to determine a reasonable period of time, all the Panel must look to is authority which Respondent cites and provides attached to its Answer to the Statement of Claim as ***Letson v. Dean Witter Reynolds, Inc.*** [N.D. CA 1982] 532 F. Supp. 500. In this, Respondent's hallmark case, is stated exactly our contention. That case involved an unrequested liquidation rather than the exact opposite in this case, an unfilled liquidation. [Respondent certainly accepts this analogy as applicable to this matter since it offered the case as authority for that premise.] With language in parenthesis added to properly reverse the situation to apply to the facts in this case, regarding whether and when an investor must act to mitigate, the court in ***Letson*** held as follows:

(A) "[T]he measure of damages under settled principles of law is the additional [lesser] amount required to repurchase [sell] the same contracts in the market within a reasonable time after liquidation." ***Id.*** at 503.

(B) "That amount is measured by the difference between the contracts' [securities] liquidation [non-liquidation] prices and the highest [lowest] intermediate prices reached by the identical contracts [securities] during a reasonable period after the wrongful sale [non-sale]." ***Id.***

(C) "This measure of damages serves two purposes, First it compensates the trader [Claimant] for lost profits by giving him the highest [lowest] price reached within a reasonable period following liquidation [non-liquidation], that price being one at which the trader [Claimant] might have sold [bought] had he not have been [had been] liquidated involuntarily [as requested]. Second, it reflects the trader's [Claimant's] duty to mitigate damages, taking into

account that the trader has no assurances that he would have been able to repurchase [sell] during the reasonable period for less [more] than the highest [lowest] intermediate price. ***Id.***

(D) "The customer [Claimant] is given a reasonable time to replace [sell] the stock ... for replacing [selling] the stock is not a condition precedent to his right to recover damages (citing ***Burnhorn v. Lockwood***, 71 N.Y.S. 828, 830 (1902)) "... the 'reasonable period' represents the time during which the trader [Claimant] is involuntarily out of [in] the market and in the process of effecting [not able to effect] reentry." ***Id.***

(E) "The general rule governing determine of reasonable time in securities cases is that a trader [Claimant] is entitled to a reasonable opportunity to consult counsel, to employ other brokers and to watch the market for the purpose of determining whether it is advisable to purchase [sell] on a particular day, or then the stock reaches a particular quotation."

Having held that the investor is entitled to the difference in price between the sale [non-sale] and the highest [lowest] intermediate price during a reasonable time, the court then analyzed a number of cases which had previously made a determination as to what is a "reasonable time". Importantly, the ***Letson*** court differentiated between securities cases and the case before it, which was a commodities case stating:

> "The instant case involves trading, not in investment securities, but in commodities futures contracts which have a limited life and turn over rapidly. The parties agree that the commodities market is volatile and unstable. Trading in it has been described as a 'fairly risky enterprise' in which the reinvestment [sale] period should be relatively short."

The court then reviewed a variety of commodities cases and concluded that in such cases, (which the court admits the time period should be shorter than in securities cases as before this Panel):

> "These decisions show that the Commission has found periods as short as one or two days to be a 'reasonable time, and has never allowed more than a calendar week (five trading days), except where a holiday has intervened, within which the trader could decide whether to reenter the market." ***Id.*** at 506.

The ***Letson*** court then found that:

> "***Letson*** was an experienced trader. He held a degree in Business Administration, had occupied various managerial positions in banks and other business enterprises and had traded commodities at Dean Witter for over two years.... These facts standing alone, make three days a reasonable repurchase period."

Furthermore, the ***Letson*** Court found that additional facts required, even in a commodities case, that the "reasonable time" must be extended beyond three days, to include the wait time for ***Letson*** to receive a response to his demand. Claimant promptly engaged an attorney and had that attorney forward a demand letter via fax, all within two days. That letter also established Claimant's position, in a totally non-speculative manner, established the price at which he would re-enter the market that day. Thereafter, the price of the shares fell further in value, establishing an even lower intermediate value to which Claimant would also be entitled had he not mitigated Respondent's damages within two days, undertaking any further risk himself. There was no response to his demand letter for until April 29, sixty-four days later! During that time, through a series of letters, Claimant documented, in a non-speculative manner, exactly his course of action, had Respondent's system not prevented him from executing his order to sell or, perhaps even more importantly, acted to mitigate the damages themselves by liquidating the securities upon learning and agreeing the order would have been executed except for the problem at Respondent. Industry standard for brokerage firms is to "stop the bleeding", then resolve the dispute.

Lastly, arbitration panels have applied the same principles as courts regarding the reasonable time and intermediate values.(***See Advest v. McCarthy***, 914 F.2d 6 (1st Cir. 1990), in which an arbitration panel ordered restitution, plus damages of the difference in the price at time of reinstatement and the highest intermediate value of the shares during a reasonable period. This Award was upheld by both the U.S. District Court and the First U.S. Circuit Court of Appeals.).

RESPONSE TO SECURITIES FIRMS' DISPOSITIVE MOTION

Martin H. Aussenberg, Esq.
Memphis, TN

[Editor's Note: This is a portion of a brief submitted by Mr. Aussenberg in a AAA arbitration which has been edited for inclusion in this publication.]

I. A Dispositive Motion Cannot Be Entertained (Or Granted) In This Proceeding

A. Neither the Parties' Agreement Nor the Rules of This Forum Permit the Lack of a Hearing in this Case

Respondents' counsel has, in its Motion to Dismiss filed as part of its letter to the AAA dated January 28, 1998, suggested that, "this dispute can be handled in a much more economical and fair manner--on the papers." While the proceedings the motion has spawned belie this assertion, it must also be stated that this is not an available method of resolving the claim. Arbitration is governed by contract, and the contract between the parties that governs this arbitration does not provide for its submission on anything less than a hearing. Indeed, the agreement calls for the arbitration to be conducted in accordance with the rules of the securities exchange or organization of which Respondents are members. Had this arbitration been before any of the SRO's of which the Respondents are members, there would be no question that this matter could not be resolved without a hearing absent an agreement between the parties to do so. See, NASD Rule 10303, NYSE Rule 602 and AMEX Rule 604 ("Any dispute...shall require a hearing unless all parties waive such hearing in writing..."). Similarly, under the AAA's securities arbitration rules, the only circumstance in which a hearing may be dispensed with is provided by Rule 38, the analog to the SRO's rules. That rule permits a dispute to be resolved "by submission of documents," but only in a simplified arbitration (i.e., where the claims do not exceed $5,000), and even then, not when any party requests an oral hearing. The rule further contemplates that the parties can agree to waive oral hearings. Indeed, the AAA's rules (Rule 31) do not permit an award to be entered without the submission of evidence even in the event one of the parties defaults. Since there has been no waiver of the Claimants' right to a hearing, the Respondents' attempt to violate that right would itself constitute a violation of the rules of the SRO's by which it is bound.[1]

B. Federal and State Law Require That A Hearing Be Held

The substantive law governing this proceeding, either the Federal Arbitration Act (9 U.S.C. §1, et seq.) ("FAA"), or the Uniform Arbitration Act (T.C.A. §29-5-301, et seq.), require that a hearing be held. The FAA provides that a court may vacate an arbitration award, "where the arbitrators were guilty of misconduct...in refusing to hear evidence pertinent and material to the controversy." (9 U.S.C. §10). The Uniform Arbitration Act provides that,

> "Unless otherwise provided by the [arbitration] agreement:
>
> . . .
>
> The parties are entitled to be heard, to present evidence material to the controversy and to cross-examine witnesses appearing at the hearing.

T.C.A.§29-5-306. It further provides that:

> Upon application of a party, the court <u>shall</u> vacate an award where:
>
> . . .
>
> (4) The arbitrators . . . refused to hear evidence material to the controversy . . . (emphasis supplied)

Federal case law is consistent with the requirement that a hearing be held in arbitration. In ***Prudential Securities, Inc. v. John B. Dalton***, 929 F. Supp. 1411 (N.D. Okla. 1996), a federal district court vacated an arbitration award that granted a pre-hearing motion to dismiss. The court found the arbitration panel "guilty of misconduct in refusing to hear evidence pertinent and material to the controversy," within the meaning of the FAA. The ***Dalton*** court held that by sustaining the motion

of the brokerage firm to dismiss, "the arbitration panel improperly denied claimant the right to a fundamentally fair hearing," and it proceeded to vacate the award and remand it to an NASD arbitration panel to "proceed with an evidentiary hearing and ruling on the merits."

II. The Motion To Dismiss Must Be Denied Under The Standards Applicable To Such Motions Even In Litigation

A. The Statement of Claim is More than Adequate to Withstand the Motion

While it is unfortunate that the Respondents see fit to attempt to import the mechanics of litigation into these proceedings,[2] even under those standards, this motion would never be granted. While couched as a motion to dismiss, the "motion" actually asks the panel to make findings of fact, without anything approaching a proper evidentiary basis. The motion provides absolutely no basis for the panel to make the various findings it would have to make in order to find the motion sustainable, including such findings as:

1. Claimants failed to notify Respondent of any discrepancies in their account;

2. Claimants failed to raise any concerns in response to letters sent by the Respondent;

3. Claimants never advised Respondent of any unauthorized or discretionary trades while they maintained their accounts at Respondent.

4. Claimants knew or should have known of their causes of action under federal and state securities law more than one year before they filed their claim.

There is absolutely no factual record on which such assertions can be based, and therefore absolutely no basis for the arbitrators to consider the mere assertion of these "facts" as sufficient evidence to grant any part of the motion which is based on those assertions. It is fundamental, even to litigation jurisprudence, that a motion to dismiss does nothing more than test the sufficiency of the "pleading" it challenges. Thus, the only issue before the arbitrators (to the extent any issue is properly before them at all in this context) is whether the Statement of Claim does that--states a claim. That is, whether, assuming that all of the facts set forth in the Statement of Claim are true (which must be assumed in such a motion), and whether, drawing all of the reasonable inferences in the Claimants' favor (which must be drawn in such a motion), the Claimants have stated any conceivable basis for recovery. Dismissal is warranted only when no set of facts will entitle the claimant to relief. ***Pemberton v. American Distilled Spirits Co.***, 664 S.W. 2d 690 (Tenn. 1984). This is elementary, and it is equally elementary that the Statement of Claim obviously survives this inquiry.

It is also equally evident that the Respondents are not entitled to have anything outside the Statement of Claim considered as part of their motion, since nothing has been properly presented. Finally, under the litigation rules applicable to such a motion, a motion to dismiss cannot be made on the basis of affirmative defenses (i.e., estoppel, ratification, statute of limitations), ***Hixson v. Stickley,*** 493 S.W.2d 471 (Tenn. 1973).

B. The Issues Raised By the Respondents' Motion Rely on Factual Determinations Which Should Not Be Made Without A Hearing

The complaint in this matter is substantially (though not exclusively) grounded in allegations of fraud and misrepresentation. The courts have determined that issues pertaining to fraud should not be decided by summary disposition. The court in ***First Tennessee Bank v. C.T. Resorts***, 1995 Tenn. App. Lexis 635(Tenn. App. 1995) held that "fraud and issues related to it are rarely susceptible to resolution by summary judgment." Similarly, the court in ***Perryman v. Peterbilt of Knoxville***, 708 S.W. 2d 403 (Tenn. App. 1985) (quoting the Tennessee Supreme Court's ruling in ***Fowler v. Happy Goodman Family***, 575 S.W.2d 496(Tenn. 1978), held that:

> . . . where a claim of fraud is presented, ordinarily only upon a full trial of the action can the issue properly be developed. As a general rule, summary judgment is not an appropriate procedure for the disposition of such an issue.

The Tennessee Court of Appeals, in ***Long v. State Farm Fire & Casualty Co.***, 510 S.W.2d 517 (Tenn. App. 1974), in reversing the grant of summary judgment in a case in

which one of the counts alleged fraudulent conduct, held:

> If [fraud is] present, it permeates the entire transaction and once charged, contractual rights or obligations cannot be determined unless the issue of fraud is first considered.
>
> While a charge of fraud may on occasion be the subject of summary judgment, such as those occasions where it is unequivocally shown that there is no material issue of fact because the charge is actually a sham or fraud of itself, but in the usual case where the action is based on a complex scheme of fraud summary judgment is inappropriate. The issue of fraud, by its nature, is one which requires for determination the actual hearing and viewing of witnesses whose credibility is of paramount concern for the trier of facts (citations omitted).

Id. at 519.

The Tennessee Court of Appeals in ***Schorr v. Schorr***, 1992 Tenn. App. Lexis 459 (Tenn. App. 1992) not only reaffirmed this principle based on its own (and Tennessee Supreme Court) precedent, it also examined the issue in the federal system, finding, as our state courts frequently do, that because the TRCP are patterned on their federal counterpart, guidance on their interpretation from the federal system is appropriate. After citing several federal cases which also hold summary judgment to be inappropriate to resolve allegations of fraud, the court cites the pre-eminent treatise on federal practice, ***Moore's Federal Practice*** which states:

> Summary judgment is apt to be inappropriate in an action based on a complex scheme of fraud ***where the court is asked to decide the motion on lengthy affidavits and documents and voluminous depositions***. In ruling on the motion, the court should remember that the movant has the burden of demonstrating clearly the absence of any genuine issue of material fact, that the court should not draw factual inferences in favor of the moving party and should not resolve a genuine issue of credibility . . .(emphasis supplied).

6 ***Moore's Federal Practice*** § 56.17[27].

B. The Question of Whether a Statute of Limitations Is a Meritorious Defense Involves a Determination Which Is Not Appropriate to Be Made on Such a Motion

Respondents' motion relies substantially on the arbitrators' acceptance of their argument that the applicable statutes of limitations bar the claim. Regardless of whether or not the Plaintiff agrees that the statutes cited by the Defendants are the ones applicable to the claims set forth in the complaint, the simple fact is that before any fact finder may grant summary disposition on the basis of a statute of limitations defense, it must determine when each of the causes of action accrued. Where the basis of the moving party's motion is a statute of limitations defense, the movant has the burden of demonstrating that there were no disputes regarding "(1)the statute of limitations properly applicable to...[the] cause of action, (2)the date on which the cause of action accrued, and (3)the date on which suit was filed."[citations omitted]. ***Wilkins v. Third National Bank of Nashville***, 884 S.W.2d 758 (Tenn. App. 1994).

The "accrual" of a cause of action "means from the time when the plaintiff knew or reasonably should have known that a cause of action existed" ***Stone v. Hinds***, 541 S.W. 2d 598, 599(Tenn. App. 1976). Thus, in order to make a finding as to the second of the aforementioned requirements with regard to the statute of limitations as a basis for summary judgment, the arbitrators must determine when the Claimants knew or should reasonably have known that a cause of action existed. As stated by the court in ***Prescott v. Adams***, 627 S.W.2d 134, 138 (Tenn. App. 1981) in reversing the Chancellor's grant of summary judgment:

> . . . the critical determination is when the cause of action accrued. We think a jury question exists on this point...The question in the instant case is when should the plaintiffs have reasonably known that their cause of action existed. We believe it is inappropriate for the Chancellor to have decided this question on the basis of a motion for summary judgment . . . we think a question of fact exists as to when the plaintiffs knew or should reasonably have known that a cause of action existed.

The weight of authority is that whether a plaintiff discovered, or in the exercise of reasonable diligence should have discovered, an injury resulting from a defendant's act creates a genuine issue of fact precluding disposition by summary judgment. ***City State Bank v. Dean Witter Reynolds, Inc.***, 1996 Tenn. App. Lexis 659 (Tenn. App. 1996).

The "knew or reasonably should have known" standard for the accrual of a cause of action is frequently also incorporated in the applicable statute of limitations, as for example, in the one cited by the Respondents with respect to the claim made under the Tennessee Securities Act (T.C.A. §48-2-122(h). It provides:

> No action shall be maintained unless commenced before the expiration of . . . one (1) year after the discovery of the facts constituting the violation, ***or after such discovery should have been made by the exercise of reasonable diligence*** . . . [emphasis supplied].

Given the fact that the question of when a cause of action accrued turns on the question of when a claimant knew or reasonably should have known that a cause of action existed, and that that question has been declared by the courts to be a genuine issue of fact that precludes disposition by summary judgment, the Respondents cannot rely on their statute of limitations defense as the basis for their requested dismissal. Put another way, under the standards enunciated in ***Wilkins, supra***, the Respondents have failed to sustain their burden of demonstrating the absence of a dispute regarding the second of the three requirements (i.e., the date on which the cause of action accrued) since that date is itself a factual determination which the Claimants dispute.

III. CONCLUSION

For all of the foregoing reasons, it is respectfully submitted that the panel refuse to entertain the Respondents' motion to dismiss.

Endnotes

1. NASD Rule 3110 prohibits the inclusion of any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration.
2. Having successfully fought to avoid the litigation of disputes with its customers, the securities industry continues to attempt to selectively import the elements of that forum when it so chooses, primarily to improperly increase its customers' misery factor in such disputes--a tactic that would be met with sanctions in that forum. Superimposing layers of impermissible procedural motions on what is supposed to be a simplified dispute resolution procedure is, at best, hypocrisy on the part of any brokerage firm who seeks to do so. Parties to voluntary arbitration may not superimpose rigorous procedural limitations on the very process designed to avoid such limitations. ***Forsythe Intl., S.A. v. Gibbs Oil Co.***, 915 F.2d 1017, 1022 (5th Cir. 1980) [***citing, Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co.***, 20 F.R.D. 359, 362 (S.D.N.Y. 1957]).

RESPONSE TO SECURITIES FIRMS' REQUESTS FOR INTERROGATORIES

L. Jerome Stanley, Esq.
Baton Rouge, LA

[Editor's Note: This is a portion of a brief submitted by Mr. Stanley which has been edited for inclusion in this publication.]

General Objection

The parties are proceeding in arbitration because Respondent ***required*** that Claimant sign an arbitration agreement as a condition of carrying a brokerage account at Respondent. This agreement provides that Claimant gives up his right to court and instead must resolve all disputes with Respondent through arbitration. The arbitration agreement itself discloses that discovery in arbitration is both different and more limited in scope than it would be in a court proceeding.

In addition to the arbitration agreement, both parties have signed an NASD submission agreement in this arbitration in which the parties agreed to conduct the arbitration under the rules and regulations of the NASD arbitration procedures, including the rules and regulations

regarding the pre-hearing exchange of documents and information.

NASD rules and regulations specifically authorize that the parties may make "requests for information" during the pre-hearing process, but do not authorize, and in fact prohibit, the use of interrogatories.

The NASD has prepared materials to train and educate its NASD arbitration hearing chairpersons. In the Chairperson Course Preparation Guide, the NASD clarifies the distinction between permissible "requests for information", on the one hand, and impermissible interrogatories on the other. The Chairperson Guide states:

> "Proper requests for information include:
>
> Who was the branch office manager?
>
> Was the current compliance manual in effect during the period in question?
>
> Who were the individuals who supervised the broker?
>
> Questions that might be asked of a witness, such as, 'What is your understanding of this document?' are improper and should generally be left for the hearing."[1]

That same NASD Chairperson Guide further states:

> ". . . while informal requests [for information] promote efficient discovery, parties should ask more formal questions at the arbitration hearing itself.
>
> For example, asking where a registered person worked might lead to further discovery with respect to those firms. It is a proper request for information.
>
> Asking about a conversation the registered person had with a supervisor is an interrogatory. This question is improper during discovery and should be asked at the hearing."

Moreover, NASD Notice to Members 99-90 also discusses permissible requests for information in NASD arbitrations and contrasts them with interrogatories. At page 691, Notice 99-90 states:

> Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require exhaustive answers or fact finding. ***Standard interrogatories, as utilized in state and federal courts, are generally not permitted in arbitration.*** [Emphasis added].

In spite of the above clear pronouncements by the NASD as to what are permissible requests for information in NASD arbitrations, Respondent has chosen to make several "requests for information" that are, without question, interrogatories. These interrogatories attempt to illicit from Claimant testimony prior to the hearing and are therefore clearly not permissible in an NASD arbitration.

The NASD rules and regulations cited above are the basis for Claimant's objections to Respondent's interrogatories as noted below.

PIABA
2241 W. Lindsey Street
Suite 500
Norman, OK 73069