

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent 1

and

Respondent 2,

Respondents.

Disciplinary Proceeding
No. C8A030100

Hearing Officer – DMF

**ORDER GRANTING IN PART AND DEFERRING IN PART COMPLAINANT'S
MOTION FOR SUMMARY DISPOSITION, AND DENYING RESPONDENTS'
MOTION FOR SUMMARY DISPOSITION**

The Department of Enforcement filed a two cause Complaint on December 29, 2003, charging that Respondent 1 (also "the Firm") and Respondent 2, its president, (1) violated NASD Rules 10101, 10301 and 2110, and IM-101100, by filing a lawsuit against two customers asserting claims that Respondents should have submitted to arbitration; and (2) violated Rule 2110 by employing abusive litigation tactics against the customers in two lawsuits. On April 19, 2004, Enforcement filed a motion for partial summary disposition and Respondents filed a motion for summary disposition, pursuant to Rule 9264. On June 24, 2004, the Hearing Panel heard oral argument on the motions. For the reasons set forth below, the Hearing Panel grants Enforcement's motion in part, defers decision on Enforcement's motion in part, and denies Respondents' motion.

FACTS¹

Respondent 1 has been an NASD member since 1983; Respondent 2 is, and at all relevant times has been, the Firm's president, as well as more than 75% owner of the Firm. He is registered with NASD, through the Firm, as a General Securities Principal. (CX 1, 2, 63.)²

In May 1995, the customers, husband and wife, opened a securities account with the Firm. When they opened the account, the Firm and the customers signed a "New Account Application," which included an "Agreement to Arbitrate Controversies" that provided as follows:

It is agreed that any controversy between us arising out of your business or this agreement, shall be submitted to arbitration conducted before the New York Stock Exchange, Inc. or any other national securities exchange on which a transaction giving rise to the claim took place (and only before such exchange) or the National Association of Securities Dealers, Inc., as the undersigned may elect and in accordance with the rules obtaining of the selected organization. Arbitration must be commenced by service upon the other party of a written demand for arbitration or a written notice of intention to arbitrate, therein electing the arbitration tribunal. In the event the undersigned does not make such election with five (5) days of such demand or notice, then the undersigned authorizes you to do so on behalf of the undersigned.

(CX 6.)

In July 1999, the customers filed an arbitration claim with NASD against Respondent 1 and others claiming various sales practice abuses and seeking damages.³ In addition to an Answer contesting the customers' claim, Respondent 1, as required by

¹ In ruling on the motions, the Hearing Panel has determined, pursuant to Rule 9264(c), that the facts set forth below appear without substantial controversy, and those facts are deemed established for purposes of this proceeding. Therefore, the Panel will hear no further evidence supporting or contesting them, and the hearing will be conducted accordingly.

² "CX" references to Complainant's Exhibits filed by Enforcement in support of its motion.

³ The other arbitration respondents were Respondent 2, _____, an officer of the Firm, _____, _____ and _____'s wife, who was an officer of _____. (CX 7.)

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

NASD Rules, filed a Uniform Submission Agreement in which, among other things, Respondent 1 agreed to "submit the present matter in controversy, ... and all related counterclaims and/or third party claims which may be asserted, to arbitration" An NASD arbitration panel conducted 14 hearing sessions, and on April 3, 2001, the panel issued an award in which the panel ordered Respondent and two other arbitration respondents, _____, the registered representative of the Firm who had serviced the customers' account, and _____, a registered investment advisor owned by _____, jointly and severally, to pay the customers a total of \$318,096.30, which included \$250,451 in compensatory damages and \$67,645.30 in costs and attorneys' fees.⁴ (CX 7-10.)

On April 23, 2001, Respondent 1, along with _____ and _____, filed a Complaint to Vacate Arbitration Award (the Review Suit) in Michigan state court, in which they asked the Michigan court to review and vacate the arbitration award, which they asserted was defective in various respects. On the same date, Respondent 1, _____ and _____ filed a separate lawsuit in the Michigan court (the Separate Suit) against the customers. The Separate Suit alleged that when they purchased the investments that were the subject of the arbitration, the customers signed subscription agreements prepared by the issuers indicating that they had received, understood and accepted the terms and conditions of the investments. The Separate Suit alleged that Respondent 1, _____ and _____ were third party beneficiaries of the subscription agreements, and that in seeking and obtaining the arbitration award, the customers had breached various

⁴ The panel also ordered the customers "to assign to Respondents ... all investments sold to [the customers] by Respondents ... that are still owned by [the customers], and furthermore [the customers] are to relinquish to Respondents ... all payments received by [the customers] in connection with said investments from the date of the assignment." The customers had settled with _____'s wife prior to the hearing and the arbitrators dismissed the claims against Respondent 2 and _____. (CX 10.)

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

warranties they had made in those agreements. Based on this third party beneficiary claim, Respondent 1, _____ and _____ sought unspecified damages from the customers in the Separate Suit. As the Firm's president, Respondent 2 authorized these suits and exercised ultimate authority over them. (CX 13-14, 63.)

Respondent 1, _____ and _____ filed an amended and a second amended complaint in the Separate Suit, as well as various other papers, and an amended complaint and other papers in the Review Suit, and the customers filed a counterclaim in the Review Suit to confirm the award. In September 2001, the Michigan court granted the customers' motions for summary judgment in both cases. On October 25, 2001, the court issued an order and judgment dismissing the Separate Suit, and an order of confirmation and judgment in the Review Suit confirming the arbitration award and dismissing the complaint to vacate the award. In dismissing the Separate Suit, the Michigan court imposed costs against the plaintiffs, including Respondent 1, based, in part, on a provision of the Michigan Court Rules authorizing such sanctions for the filing of "a frivolous claim." (CX 15-17, 19-33.)

Respondent 1, _____ and _____ filed motions asking the Michigan court to reconsider its determinations in both the Review Suit and the Separate Suit, which the court denied. They also filed a number of other post-judgment motions, all of which the court denied. On May 16, 2002, the court issued an order in which it denied some of these motions, ordered that "Plaintiffs must obtain the Court's approval in advance to file any more Motions in this action," and found "Plaintiffs' Motions to be in bad faith and Plaintiffs and Plaintiffs' counsel, jointly and severally, are hereby ordered to pay to the

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

Defendants the sum of One Thousand (\$1,000) Dollars as costs and attorneys' fees incurred in connection with defending against these Motions." (CX 34-52.)

Respondent 1 subsequently appealed the Michigan court's decisions to the Michigan Court of Appeals. On February 19, 2004, the Court of Appeals issued an opinion affirming the lower court's dismissal of the Separate Suit and its confirmation of the arbitration award in the Review Suit. In its discussion of the Separate Suit, the Court of Appeals held that, as a result of the decision in the arbitration case, Respondent 1 was precluded from asserting the third party beneficiary claim in the Separate Suit, under principles of res judicata. The Court of Appeals found that, pursuant to the language in the Uniform Submission Agreement that required the submission of "all related counterclaims and/or third party claims," Respondent 1 was required to assert the third party beneficiary claim in the arbitration and that, having failed to do so, Respondent 1 was barred from asserting it in the Separate Suit. Noting that the arbitration provisions in the New Account Application applied to "any controversy" arising out of the customers' "business," the Court of Appeals explained:

Thus, the question of any third party beneficiary or breach of warranty claim should have been submitted at arbitration. [the Firm's] attempt to distinguish the new account arbitration provision from the subscription agreements is without merit in light of the broad arbitration language applicable to the parties' "business" relationship.

The Court of Appeals also affirmed the lower court's imposition of costs in the Separate Suit, and remanded the Review Suit, directing the lower court to determine and award to

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

the customers "attorney fees arising from both the circuit court action and this appeal."
(CX 53.)⁵

DISCUSSION

Rule 9264 provides that either the Complainant or the Respondent may move for summary disposition of any or all of the causes of action against the Respondent set forth in the Complaint, or any affirmative defense asserted by the Respondent in the Answer. The Hearing Panel may grant summary disposition if there is no genuine issue with regard to any material fact and the moving party is entitled to summary disposition as a matter of law. "[T]he moving party bears the burden of demonstrating the absence of a genuine issue of material fact.... If the moving party meets this burden, the opposing party must come forward with specific facts showing that there is a genuine issue in dispute.... Absent such a showing, summary disposition is appropriate." Department of Enforcement v. Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *10 n. 11 (NAC June 2, 2000) (citations omitted).

The first cause of the Complaint charges that Respondent 1 violated Rules 10101, 10301 and 2110, and IM-10100, by filing the Separate Suit, rather than submitting the claim to arbitration, and that Respondent 2 was responsible for Respondent 1's violation. Enforcement argues that, based upon the undisputed facts, it is entitled to summary disposition on this charge and the Hearing Panel agrees.

Rule 10101 provides that "any dispute, claim or controversy arising out of or in connection with the business of a member of the Association" between the member and public customers is eligible for arbitration under the NASD Code of Arbitration

⁵ Respondent 1 filed applications with the Michigan Supreme Court for leave to appeal the Court of Appeals decision (CX 54-55), but at oral argument Respondent 1's counsel advised the Hearing Panel that Respondent 1 has withdrawn those applications. Thus, the Court of Appeals decision is final.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

Procedure. The claims asserted in the Separate Suit were, therefore, eligible for arbitration.

Rule 10301(a), under the heading "Required Submission," provides: "Any dispute, claim or controversy eligible for submission under the Rule 10100 Series between a customer and a member ... shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer." The New Account Application provided that Respondent 1 and the customers agreed to arbitrate "any controversy" arising out of the customers' business with Respondent 1, which included the third party beneficiary claim that Respondent 1 sought to raise in the Separate Suit.

Respondent 1 argues that, nevertheless, it did not violate Rule 10301(a) because the customers did not "demand" arbitration of that claim. The Hearing Panel, however, rejects this argument for several reasons. First, the customers did demand arbitration by filing their arbitration claim in July 1999. Although Respondents argue that they could not have raised, and were not required to raise, their third party beneficiary claim in that proceeding, the Michigan Court of Appeals squarely rejected those arguments, holding that because Respondent 1 failed to raise the claim in the arbitration proceeding, Respondent 1 was barred from attempting to assert it in the Separate Suit. The Hearing Panel finds no basis for rejecting the Court of Appeals' holding in that regard. Further, in their answer to the Separate Suit and thereafter in successfully moving to dismiss that suit, the customers insisted that Respondent 1 was required to submit the third party beneficiary claim to arbitration, and both the Michigan trial court and the Court of Appeals agreed.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

In any event, Rule 10301(a) is phrased in the alternative. An NASD member such as Respondent 1 must arbitrate if either there is “a duly executed and enforceable written agreement” to arbitrate with the customer or the customer demands arbitration. In this case, because there was an agreement to arbitrate, Respondent 1 had an affirmative obligation under Rule 10301(a) to assert its claim through the arbitration process. It could not, consistent with Rule 10301(a), file its claim in court, and impose on the customers the burden of demanding arbitration in that forum. The Hearing Panel, therefore, finds that the undisputed facts establish that Respondent 1 violated Rule 10301(a) by failing to submit the claim raised in the Separate Suit to arbitration.

IM-10100 warns: “It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member ... to: (a) fail to submit a dispute for arbitration under the NASD Code of Arbitration Procedure as required by that Code.” Respondents argue that this language is permissive – “may be deemed” – rather than mandatory, and that the Hearing Panel should not find a violation through summary disposition, without hearing all the evidence. The Panel disagrees. As explained above, Enforcement has established through undisputed facts that Respondent 1 had an obligation to arbitrate its claim, but nevertheless filed the Separate Suit. In opposing Enforcement’s motion, Respondents failed to adduce any evidence that would establish the existence of any genuine issue of material fact in that regard. Mere argument does not create a genuine issue of material fact or justify withholding summary disposition if, as here, it is appropriate under the undisputed facts. Accordingly, the Hearing Panel finds that by violating Rule 10301(a), Respondent 1 also violated Rule 2110.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

Finally, the undisputed facts establish that at all relevant times Respondent 2 was the Firm's president and was responsible for the Firm's decision to pursue the Separate Suit; Respondent 2 himself acknowledged, "the buck stops here." It is well established that "the president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient." William H. Gerhauser, Sr., 53 S.E.C. 933, 940-41, 1998 SEC LEXIS 2402, at *17-18 (Nov. 4, 1998). The Panel, therefore, finds that Respondent 2 also violated Rule 2110.

The second cause of the Complaint charges that Respondents violated Rule 2110 by employing abusive litigation tactics against the customers in both the Separate Suit and the Review Suit. Rule 2110 requires that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade." In Department of Enforcement v. Shvarts, the National Adjudicatory Council (NAC) defined the reach of Rule 2110:

Conduct Rule 2110 "is not limited to rules of legal conduct but rather . . . it states a broad ethical principle." . . . Disciplinary hearings under Conduct Rule 2110 are ethical proceedings, and one may find a violation of the ethical requirements where no legally cognizable wrong occurred. . . . The NASD has authority to impose sanctions for violations of "moral standards" even if there was no "unlawful" conduct.

2000 NASD Discip. LEXIS 6, at *11 (citations and footnote omitted). The NAC further explained (id. at *12-13):

In the caselaw developed under the rule, some types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. . . .

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

Other types of violations, such as failures to honor obligations imposed by private contracts, are viewed as violations of Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and "bad faith" may be employed to determine whether conduct is unethical in these cases.

In Shvarts, the NAC found that the respondent violated Rule 2110 "by failing to comply with a court judgment awarding to his former customers the attorney fees and costs they incurred in litigation that he filed against them challenging an arbitration award they had won from him." Id. at * 1. In this case Enforcement contends that Respondents violated Rule 2110 not by failing to comply with a court order – relatively objective misconduct – but by utilizing abusive litigation tactics.

There is language in the Shvarts decision to support the application of Rule 2110 to such conduct. In particular, the NAC explained that Rule 2110 "obviously applies to dealings with securities customers," including arbitration proceedings arising out of the customers' business, and that "[c]ourt proceedings relating to arbitration are a foreseeable aspect of commercial dealings with customers." Id. at *20. The NAC also indicated that the respondent's conduct was unethical, in violation of Rule 2110, "because it undermined the NASD's regulatory functions by discouraging customer use of the arbitration system." Id. at 25. Utilizing abusive litigation tactics against customers who have obtained a favorable arbitration award could similarly discourage the use of the arbitration system and undermine its effectiveness.

Furthermore, there is objective evidence that Respondents employed abusive litigation tactics against the customers in the Separate Suit and the Review Suit. In dismissing the Separate Suit, the Michigan court imposed costs against Respondent 1 and the other plaintiffs based, in part, on a provision of the Michigan Court Rules authorizing

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

such sanctions for the filing of “a frivolous claim.” Then, in denying post-judgment motions in the Review Suit, the Michigan court ordered the plaintiffs, including Respondent 1, to obtain the court’s approval before filing any additional motions, an extraordinary step, found that the plaintiffs’ motions had been in bad faith and ordered them to pay the customers \$1,000 for costs and attorney fees incurred in contesting the motions.⁶

In spite of this, the Hearing Panel concludes that it is prudent to defer ruling on Enforcement’s request for summary disposition as to the second cause of the Complaint until the hearing. First, it will be necessary, in any event, to hold a hearing on the issue of sanctions; second, the liability issue under the second cause is novel, and the testimony presented at the hearing may help clarify the applicability of Rule 2110 to the circumstances presented. Furthermore, in addition to relying on the objective evidence of abuse discussed above to support its Rule 2110 charge, Enforcement has argued that Respondents pursued the litigation tactics as “a transparent attempt to intimidate and punish [the customers] for obtaining a favorable NASD Arbitration Award.”

(Memorandum in Support of Complainant’s Motion for Partial Summary Disposition at 21.) While, as explained above, bad faith in the sense of malevolence is not required to establish a Rule 2110 violation, proof that Respondents intended to “intimidate and punish” the customers would lend additional support to Enforcement’s charge, but the Hearing Panel cannot find that Respondents had such an intent based on the undisputed

⁶ At oral argument, Respondents’ counsel argued that it was not clear whether the sanctions were imposed on Respondent 1 or the other plaintiffs, but the Michigan court’s orders clearly applied to all of the plaintiffs, including Respondent 1, and in fact Respondent 1 ultimately paid the sanctions. (CX 56-58.) Furthermore, the Complaint initiating the Separate Suit, which the court found to be a frivolous claim, and the motions that the court found were filed in bad faith either were filed by Respondent 1 on only its behalf, or were signed by Respondent 1’s counsel on behalf of all plaintiffs. (CX 13, 50, 51.)

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 04-11 (C8A030100).

facts.⁷ Testimony at the hearing, however, may shed additional light on the issue, one way or the other.

Finally, the Hearing Panel denies Respondents' motion for summary disposition. In that motion, Respondents urge the Hearing Panel to dismiss both causes of the Complaint, raising a flurry of arguments that are effectively addressed and rejected in the preceding discussion of Enforcement's motion. In particular, for reasons set forth above, the Hearing Panel rejects Respondents' contentions that they were not required to arbitrate the third party beneficiary claim raised in the Separate Suit and that Rule 2110 could not be applied to Respondents, even if the Hearing Panel were to conclude that they employed abusive litigation tactics against the customers.

Therefore, Enforcement's motion for partial summary disposition is granted as to the first cause of the Complaint and deferred as to the second cause, and Respondents' motion for summary disposition is denied.

SO ORDERED.

David M. FitzGerald
Hearing Officer
for the Hearing Panel

Dated: July 7, 2004

⁷ When Respondent 2 testified under oath during NASD staff's investigation, he was asked, "To your knowledge, did anyone at [the Firm] ever make a statement to the [customers] or the [customers'] attorney that they would never see a penny of the arbitration award?" He responded, "Absolutely not." (CX 63.)