

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant

v.

Respondent.

Expedited Proceeding
No. ARB060031

Hearing Officer—RSH

DECISION

April 16, 2007

Respondent failed to pay an arbitration award, in violation of Rule 10330(h) of the NASD Code of Arbitration, and Respondent failed to demonstrate that he had a *bona fide* inability to pay the award. In accordance with Article VI, Section 3 of NASD By-Laws and NASD Procedural Rules 9554 and 9559(n), Respondent's registration is suspended.

Appearances

Karrin Feemster, Senior Regional Attorney and David A. Greene, Deputy Regional Chief Counsel, Los Angeles, CA and Rory C. Flynn, Esq., Chief Litigation Counsel, Washington, DC, for Complainant.

Cary S. Lapidus, San Francisco, CA for Respondent.

DECISION

I. Introduction

On October 12, 2006, NASD's Office of Dispute Resolution notified Respondent by letter that his registration would be suspended in accordance with NASD Procedural Rule 9554

because of his failure to pay an arbitration award.¹ On November 2, 2006, Respondent filed his request for a hearing, claiming that he had a *bona fide* inability to pay the arbitration award.²

Pursuant to Procedural Rules 9559(d) (1) and 9559(d) (5), the Hearing Officer conducted a hearing by telephone on January 17, 2007. The Parties submitted 11 joint exhibits, the Department of Enforcement (“Enforcement”) submitted 5 supplemental exhibits and the Respondent submitted 22 additional exhibits. In addition, the Respondent, his mother and his father-in-law testified at the hearing. The Respondent offered no other evidence. Enforcement cross-examined the Respondent and his witnesses regarding his financial situation.³

The Respondent concedes that he has not paid the arbitration award.⁴ He contends that he is financially unable to do so, while Enforcement argues that he failed to establish a *bona fide* inability to pay because he has adequate resources to pay the award or some meaningful portion of it. After a review of the entire record, the Hearing Officer finds that the Respondent failed to demonstrate his *bona fide* inability to pay the arbitration award. Accordingly, the Respondent’s registration is suspended.

II. Findings of Fact and Conclusions of Law

A. Background

Respondent, who was registered with NASD through various employers between 1989 and 2003, is currently not associated with an NASD member firm. He is employed as the sole Investment Advisor Representative of [Firm H], a registered investment advisor.⁵ Respondent

¹ JX-5. “JX” refers to exhibits submitted jointly by the Department of Enforcement and Respondent. “RX” refers to the Respondent’s additional exhibits. “CX” refers to the Department of Enforcement’s additional exhibits.

² JX-6.

³ The hearing transcript is cited “Tr.” followed by the page number.

⁴ Tr.8-9.

⁵ Tr. at 46-47.

was registered as a General Securities Representative with NASD member firm [Claimant] from June 2002 to June 2003. According to Respondent's Central Registration Depository record, he voluntarily terminated his employment with Claimant and has not been registered with NASD since then.⁶

On February 2, 2004, Claimant filed an arbitration claim against Respondent, NASD Arbitration No. 04-00615, alleging that Respondent had breached his employment contract and committed various other offenses against Claimant in connection with his employment. On April 5, 2005, Respondent filed an arbitration counter-claim, alleging that Claimant had, *inter alia*, wrongfully terminated and defamed him. After 22 hearing sessions, on August 22, 2006, a hearing panel awarded Claimant \$550,000 of its claim against Respondent and awarded Respondent \$225,000 of his claim against Claimant⁷ That same day, NASD's Office of Dispute Resolution served Respondent's counsel of record with a copy of the award and a cover letter that advised the Respondent of his obligation under Rule 10330(h) to satisfy the award within 30 days.⁸ On September 26, 2006, a California State Court confirmed the arbitration award. The Court ordered that the award, "which resulted in a net award of \$325,000 in favor of [Claimant] is confirmed in all respects." Respondent does not dispute this confirmation of the award.⁹

Respondent made no payments to Claimant. Accordingly, as described above, Enforcement commenced this proceeding to suspend Respondent's association with any member firm in any capacity.

⁶ JX-1.

⁷ JX-2, JX-3.

⁸ JX-3.

⁹ Tr. at 88.

B. Jurisdiction

Although Respondent has not been registered with NASD since 2003, NASD retains jurisdiction over him for purposes of this suspension proceeding because this proceeding was brought within two years after the date of entry of the arbitration award.¹⁰

C. Inability to Pay Standard

NASD's arbitration process is designed to provide efficient resolution of disputes involving NASD members, their employees, and the public.¹¹ To ensure compliance with arbitration awards, NASD has promulgated rules to allow for expedited suspension proceedings against members and associated persons, or formerly associated persons, for failing to abide by such awards.¹²

A respondent may assert certain limited defenses in an expedited suspension proceeding. These include: (1) the award has been paid in full; (2) the parties have agreed to installment payments of the amount awarded, or have otherwise agreed to settle the action, and the respondent is not in default of the terms of the settlement agreement; (3) the award has been vacated by a court; (4) a motion to vacate or modify the award is pending in a court; and (5) the respondent has a bankruptcy petition pending in U.S. Bankruptcy Court, or the award has been

¹⁰ Article 5, Sec. 4(b) of NASD By-Laws.

¹¹ *Eric M. Diehm*, Exchange Act Release No. 33478, 1994 SEC LEXIS 148, at *4 (Jan. 14, 1994) (internal citation omitted).

¹² NASD By-Laws, Article VI, Section 3; NASD Procedural Rule 9550, *et seq.* See also Notice to Members 00-55 (August 2000) and 04-36 (May 2004).

discharged by a U.S. Bankruptcy Court.¹³ In addition, a respondent may assert a *bona fide* inability to pay the award,¹⁴ as Respondent has in this case.

Respondent has the burden to establish his inability-to-pay defense, “because the scope of his assets is peculiarly within [his] knowledge.”¹⁵ More importantly, NASD is entitled to make a searching inquiry into his assertion.¹⁶ To this end, on November 6, 2006, Enforcement sent Respondent a request for financial information and documentation to substantiate his claim.¹⁷ On December 4, 2006, Respondent sent Enforcement Exhibits RX-1 through RX-22.¹⁸ Enforcement considered the response deficient and requested additional information. Subsequently, Respondent’s counsel discussed the matter with Enforcement. Then, Respondent supplemented his response with the documents contained in JX-10.

Respondent’s financial documents were submitted and many were reviewed at the hearing.

D. Respondent’s Financial Condition

1. Income

Respondent lives in Orinda, California with his wife and three children, ages 14, 13 and 7.¹⁹ After leaving [the Claimant firm] in June 2003, Respondent started Firm H, a fee-only

¹³ NASD By-Laws, Article VI, Section 3; NASD Notice to Members 00-55, 2000 NASD LEXIS 63 (Aug. 2000).

¹⁴ See, e.g., *William J. Gallagher*, Exchange Act Release No. 47501, 2003 SEC LEXIS 599 (Mar. 14, 2003).

¹⁵ *Bruce M. Zipper*, Exchange Act Release No. 33376, 1993 SEC LEXIS 3525, at *8 (Dec. 23, 1993).

¹⁶ *Daniel Joseph Avant*, Exchange Act Release No. 36423, 1995 SEC LEXIS 2816, at *11 (Oct. 26, 1995); *Zipper*, 1993 SEC LEXIS 3525, at *8.

¹⁷ JX-7.

¹⁸ Also contained in JX-8.

¹⁹ Tr. at 43.

investment advisor. Firm H employs Respondent, his wife and one other person.²⁰ Currently, both Respondent and his wife derive their income solely from Firm H. Their income in 2006 totaled approximately \$270,000--\$240,000 from Respondent and \$30,000 from his wife.²¹ According to their joint tax return, in 2005 their adjusted gross income (“AGI”) was \$215,240. In 2004, Respondent’s gross income from Firm H was \$112,000; his wife did not work for Firm H in 2004.²²

2. Expenses

Respondent testified that his current income does not meet his and his family’s living expenses, which are approximately \$20,000 per month.²³ After reviewing the documents submitted and discussed at the hearing, the Hearing Officer found that his family’s annual expenses are approximately \$252,000, which is more than his annual net income for the past three years.²⁴ Respondent testified that he had met the shortfall in the past by using a home equity line of credit of approximately \$250,000.²⁵ As of October 2006, the balance owed on this line of credit was \$248,962.²⁶ Respondent’s 81-year old widowed mother, a Ukrainian immigrant, testified that in 1995 she loaned him \$100,000 at 8% interest to make a down payment on a home in Los Angeles.²⁷ For the past several years, Respondent has been borrowing money from his mother to pay his living expenses. Essentially, she has extended him a personal line of credit. [Respondent’s wife] and the Respondent testified that she loaned him money as he

²⁰ Tr. at 46.

²¹ Tr. at 77, CX-4 at 2.

²² Tr. at 77.

²³ Tr. at 78, 122.

²⁴ Tr. at 78-82, 126-147; JX-8 at 234, 298-319.

²⁵ Tr. at 52-54.

²⁶ Tr. at 53; JX-8 at 233.

²⁷ Tr. at 18-20.

needed it and he paid her back when and if he was able to.²⁸ Respondent testified that his current indebtedness to his mother fluctuates at around \$200,000-\$220,000, depending on his own cash flow.²⁹

3. Liabilities

In addition to Claimant's arbitration award, Respondent's lawyers in the arbitration have filed a lien in the amount of \$138,000 against him based on their entitlement to 40% of the \$225,000 award they "won" for Respondent.³⁰

In addition to the approximately \$200,000 Respondent owes to his mother, Respondent owes his father-in-law, DS, approximately \$50,000. DS loaned Respondent \$20,000 at 8% interest in August 1995 to be used for part of a down payment on the house in Los Angeles.³¹ DS testified that with accrued interest, the debt is now approximately \$50,000.³²

4. Assets

Respondent's main asset is the home he and his family live in. Its value is between \$1.4 and \$1.6 million.³³ It is encumbered by a mortgage of \$980,000 plus the line of credit balance of \$248,933.³⁴ Respondent testified that he believes his debts to his mother and father-in-law should take precedence over his debt to Claimant because they were incurred earlier than the

²⁸ Tr. at 21, 29-32.

²⁹ Tr. at 55.

³⁰ JX-11 at 2-3.

³¹ Tr. at 35; JX-10 at 64.

³² Tr. at 41.

³³ Tr. at 66-68; JX-8 at 238; JX-10 at 56. Enforcement argued that Respondent's house is worth much more than its appraised value. Enforcement supported its contention with its attorney's "belief" that the house had appreciated more than 25% in three years simply "by virtue of the California real estate market." The attorney's belief is obviously not evidence and was not given any weight by the Hearing Officer.

³⁴ Tr. at 55; JX-8 at 8, 232, 233.

arbitration award.³⁵ Because of that, on August 31, 2006, he recorded deeds of trust giving them security interests in his home totaling \$212,025.³⁶ The total indebtedness on his home is therefore approximately \$1,440,958. Respondent testified that his banker told him he could not qualify for any additional credit based on his home.³⁷

Respondent's other major asset is his Individual Retirement Account ("IRA"), which at the time of the hearing contained approximately \$485,000.³⁸ Respondent testified that he had not liquidated his IRA because he was saving it for his children's college education and because of the early withdrawal penalty and income taxes he would pay on the amount withdrawn. He estimated that he would realize only \$212,000 after the penalty and taxes.³⁹

E. Discussion

Based on the foregoing, the Hearing Officer concluded that Respondent has sufficient assets to make a meaningful contribution towards payment of the arbitration award against him. While the income he has previously earned through Firm H has not been sufficient to meet his living expenses, it has been steadily increasing. Respondent's IRA is a large, untapped asset; it is his choice not to use it to pay the arbitration award. Although it may be a perfectly reasonable economic decision not to do so, the fact remains that the IRA is a viable asset for him to use. And while his decision to give preference to the debts owed to his mother and father-in-law may be morally laudable, they are clearly not debts that require immediate payment. Yet, he chose to effectively transfer \$212,000 of a potential source of credit to them instead of using it to pay the arbitration award.

³⁵ Tr. at 57.

³⁶ Tr. at 61; JX-8 at 5, 72-81.

³⁷ Tr. at 162-163.

³⁸ JX-8 at 2, 100, 109.

³⁹ Tr. at 74-75.

An inability-to-pay defense may be rejected when it appears that the respondent could borrow the funds, or could make some meaningful payment toward the award from available assets or income, even if he is unable to pay the full award.⁴⁰ The Hearing Officer finds that Respondent did not meet the burden of proving a *bona fide* inability to pay the award. Respondent chose to further encumber his home by paying the debts owed his mother and father-in-law rather than borrowing to pay the arbitration award. Presumably, his mother and father-in-law could release their security interests if Respondent asked them to. Respondent has also chosen to retain a significant asset, his IRA, rather than liquidate or borrow against it. Therefore, he has the ability to pay at least a significant portion of the award, but has chosen not to do so. That is, of course, his right; however, the consequence of that choice is that he may not be registered with NASD until he pays the arbitration award.

III. Conclusion

The Hearing Officer finds, and the parties do not dispute, that the Respondent has failed to pay any portion of the arbitration award at issue. The Hearing Officer further finds that the Respondent has failed to establish any of the limited defenses permitted by NASD rules or case law and specifically failed to demonstrate the defense he asserted, a *bona fide* inability to pay.

Accordingly, pursuant to Article VI, Section 3 of NASD By-Laws and Rule 9559(n), Respondent's registration is suspended effective as of the date of issuance of this Decision. The suspension shall continue until Respondent provides documentary evidence to NASD showing that: (1) the award has been paid in full; (2) he and the claimant have agreed to settle the matter;

⁴⁰ *District Bus. Conduct Comm. v. Escalator Securities, Inc.*, No. C07930034, 1998 NASD Discip. LEXIS 21 (N.B.C.C. Feb. 19, 1998); *District Bus. Conduct Comm. v. Cruz*, No. C8A930048, 1997 NASD Discip. LEXIS 62 (N.B.C.C. Oct. 31, 1997); *Herbert Garrett Frey*, Exchange Act Release No. 39007, 1997 SEC LEXIS 1796 (Sept. 3, 1997); *Michael H. Novick*, Exchange Act Release No. 37503, 1996 SEC LEXIS 1994 (July 31, 1996); *District Bus. Conduct Comm. v. Zipper*, No. C07910138, 1994 NASD Discip. LEXIS 194 (N.B.C.C. Oct. 31, 1994), *aff'd*, Exchange Act Release No. 35606, 1995 SEC LEXIS 981 (Apr. 17, 1995).

or (3) he has filed a petition in a United States Bankruptcy Court, or the debt has been discharged by a United States Bankruptcy Court.

In addition, the Respondent is ordered to pay NASD a total of \$1, 940.25 in costs, which includes an administrative fee of \$750 and hearing transcript costs of \$1,190.25.⁴¹ The fine and costs shall become due upon the issuance of this Decision.

Rochelle S. Hall
Hearing Officer

⁴¹ The Hearing Officer has considered all of the arguments made by the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.