

**Award**  
**NASD Dispute Resolution, Inc.**

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In the Matter of the Arbitration Between

Name of Claimant

The Estate of Virgil Adolph Guenther, by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet

Case No. 00-03078

Name of Respondents

J.E. Liss & Co., Inc.; Liss Financial Services; Jerome E. Liss; and Red Oak Financial Corporation

Hearing Site: Milwaukee, Wisconsin

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**REPRESENTATION OF PARTIES**

Claimants The Estate of Virgil Adolph Guenther by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet were represented by Paul R. Erickson, Esq., of the firm of Gutlass Erickson Bonville, S.C., located in Milwaukee, Wisconsin.

Respondents J.E. Liss & Co., Inc.; Liss Financial Services; Jerome E. Liss; and Red Oak Financial Corporation were represented by Michael H. Schaalman, Esq., of the firm of Quarles & Brady LLP, located in Milwaukee, Wisconsin.

**CASE INFORMATION**

Statement of Claim filed on or about: July 20, 2000.

Claimants The Estate of Virgil Adolph Guenther, by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet signed the Uniform Submission Agreement: June 13, 2000.

Statement of Answer filed by Respondents J.E. Liss & Co., Inc. and Jerome E. Liss on or about: January 26, 2001.

Respondent J. Liss signed the Uniform Submission Agreement: January 26, 2001.

Claimants' Motion to Bar Respondents from Presenting Any Matter, Facts, Arguments or Defenses at Hearing filed: January 24, 2001.

Claimants' Brief in Support of Motion to Bar Respondents from Presenting Any Matter, Facts, Arguments or Defenses at Hearing filed: January 24, 2001.

Response to Claimants' Motion to Bar Respondents from Presenting Any Matter, Facts, Arguments or Defenses at Hearing filed by Respondent Liss & Co. and J. Liss on or about: February 19, 2001.

Claimants' Reply Brief Regarding Motion to Bar Respondents from Presenting Any Matter, Facts, Arguments or Defenses at Hearing filed: March 6, 2001.

### **CASE SUMMARY**

Claimants asserted the following causes of action:

1. Violation of Sections 10(b) and 20 of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission;
2. Breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing;
3. Violation of NYSE Rules 342, 401 and 405 "Know Your Customer Rules";
4. Intentional misrepresentation and negligent misrepresentation; and,
5. Misrepresentation.

These causes of action resulted from Respondents' actions in regard to a transaction in Arch Leasing Collateralized Trust Bonds.

Unless specifically admitted in its Answer, Respondent Liss & Co. and J. Liss denied the allegations made in the Statement of Claim and asserted the following defenses:

1. Margadette Demet and Kevin Demet, as fiduciaries of the Estate, are responsible to determine whether investments they purchase are appropriate for the Estate. If they failed to meet their fiduciary duty, they alone are liable for any losses suffered by the estate;
2. Because they relied on the Demets' knowledge, expertise and experience, the Claimants cannot show that they reasonably relied on any statement made by J. Liss;
3. Claimants unfairly waited to file their claim for more than two years following notice to them that Arch Leasing could not repay their principal in full;
4. Claimants have contributory fault because their agents, Margadette Demet and Kevin Demet, failed to advise them about the published risks associated with the Trust Bonds;
5. Any claims of fraud are barred by the statute of limitations; and,
6. Red Oak is not a member of the NASD and is not subject to any award by the NASD.

**RELIEF REQUESTED**

Claimants requested compensatory damages in an amount not less than \$300,000.00; loss of use of invested capital in an amount to be proven at hearing; benefit of the bargain damages in an amount to be proven at the hearing; costs of arbitration and reasonable attorneys' fees; punitive damages and damages in an amount to be determined by the arbitrators; and such other relief as the arbitrators deemed just and equitable.

Respondents requested Liss & Co. and J. Liss requested that the Statement of Claim be dismissed with prejudice together with an award of costs and attorneys fees incurred in defending the arbitration.

**OTHER ISSUES CONSIDERED AND DECIDED**

Red Oak Financial Corporation is a non-member of the NASD who did not voluntarily submit to arbitration. Therefore, the panel made no determination in regard to any claims against Red Oak Financial Corporation.

Respondent J.E. Liss & Co. did not file with NASD Dispute Resolution, Inc. a properly executed submission to arbitration, but is required to submit to arbitration pursuant to the Code and having answered the claim, appeared and testified at the hearing, is bound by the determination of the Panel on all issues submitted.

Respondent Liss Financial Services did not file with NASD Dispute Resolution, Inc. a properly executed submission to arbitration. The panel determined that Liss Financial Services was not an entity separate from J.E. Liss & Co., but instead was the "doing business as" name for J.E. Liss & Co.

On March 16, 2001, the parties were advised that the panel had reviewed Claimants' Motion to Bar Respondents from Presenting Any Matter, Facts, Arguments or Defenses at Hearing, as well as all subsequent pleadings relating to the Motion, and the panel determined that the Motion was denied.

At hearing, Respondents moved to dismiss allegations in the Statement of Claim. After considering the arguments, the panel determined that it would take the motion under advisement. The motion is rendered moot by the panel decision.

**AWARD**

After considering the pleadings, the testimony and evidence presented at the hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. The claims asserted by Claimants The Estate of Virgil Adolph Guenther, by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet are dismissed and denied in their entirety;
2. The parties shall bear their own costs of arbitration, including any attorneys' fees, except for those specifically enumerated herein; and
3. Any and all relief not specifically addressed herein, including punitive damages, is denied.

### **FEES**

Pursuant to the Code, the following fees are assessed:

#### **Filing Fees**

NASD Dispute Resolution, Inc. will retain or collect the non-refundable filing fees for each claim:

Initial claim filing fee	= \$ 300.00
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#### **Member Fees**

Member fees are assessed to each member firm that is a party in these proceedings or to the member firms that employed the associated persons at the time of the events giving rise to the dispute. In this matter, the member firm is a party.

Member surcharge	= \$ 1,500.00
Pre-hearing process fee	= \$ 600.00
Hearing process fee	= \$ 2,500.00

#### **Adjournment Fees**

Adjournments requested during these proceedings:

June 25-29, 2001 adjournment by Respondents panel).	= \$ 1,125.00 (waived by
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#### **Forum Fees and Assessments**

The panel has the authority to assess forum fees for each hearing session conducted. A hearing session is any meeting between the parties and the arbitrators, including a pre-hearing conference with the arbitrators, that lasts four (4) hours or less. Fees associated with these proceedings are:

One (1) Pre-hearing session with Panel x \$1,125.00	= \$ 1,125.00
Pre-hearing Date: January 30, 2001 1 session	
Ten (10) Hearing sessions x \$1,125.00	= \$11,250.00

Hearing Dates:	December 3, 2001	2 sessions
	December 4, 2001	2 sessions
	December 5, 2001	2 sessions
	December 6, 2001	2 sessions
	December 7, 2001	2 sessions
<hr/> Total Forum Fees		= \$12,375.00

The panel has assessed \$6,187.50 of the forum fees to Claimants The Estate of Virgil Adolph Guenther, by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet. In addition, the panel has assessed \$6,187.50 of the forum fees, jointly and severally, to Respondents J.E. Liss & Co., doing business as Liss Financial Services, and Jerome E. Liss.

#### **EEE SUMMARY**

Claimants The Estate of Virgil Adolph Guenther, by its personal Representative, Margadette M. Demet; Virgil Guenther, Jr. Revocable Living Trust, by its trustee, Margadette M. Dent; and Ardell Guenther, by his guardian, Kevin Demet are jointly and severally liable for:

Initial Filing Fee	= \$ 300.00
Forum Fees	= \$ 6,187.50
Total Fees	= \$ 6,487.50
Less payments	= \$ 1,425.00
Balance Due NASD Dispute Resolution, Inc.	= \$ 5,062.50

Respondents J.E. Liss & Co., doing business as Liss Financial Services, and Jerome E. Liss are jointly and severally liable for:

Forum Fees	= \$ 6,187.50
Less payments	= \$ 00
Balance Due NASD Dispute Resolution, Inc.	= \$ 6,187.50

Respondent J.E. Liss & Co., doing business as Liss Financial Services, is solely liable for:

Member Fees	= \$ 4,600.00
Less payments	= \$ 2,100.00
Balance Due NASD Dispute Resolution, Inc.	= \$ 2,500.00

All balances are due to NASD Dispute Resolution, Inc.

#### **ARBITRATION PANEL**

Thomas F. Mahoney, Esq. - Public Arbitrator, Presiding Chair

Philip P. Rummel, Esq. - Public Arbitrator  
Elise M. Neils, J.D. - Non-Public Arbitrator

**Concurring Arbitrators' Signatures**

Thomas F. Mahoney  
Thomas F. Mahoney, Esq.  
Public Arbitrator, Presiding Chair

1 February 2002  
Signature Date

Elise M. Neils, J.D.  
Non-Public Arbitrator

Signature Date

**DISSENT**

I dissent in part and concur in part of the majority's finding that Claimants did not prove that Respondents incurred any liability on any of the five claims.

1. I dissent from the majority's holding that J.E. Liss & Company ("Liss Co.") did not violate the provisions of Section 10B of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission. I hold that Liss Co. did violate the aforesaid provisions and that the damages proximately caused were \$162,000 (one-half thereof to Ardell Guenther's guardianship estate and one-half thereof to the Virgil Guenther, Jr. Revocable Living Trust). The Estate and the beneficiaries thereof received all the promised interest for the three years the Trust Bonds were to be outstanding and then received \$99,500 in principal, leaving the beneficiaries with a loss of \$205,510. I computed the above-described damages using a rescissionary method giving the Respondents the benefit of the excess return over a 5% rescissionary interest computation.


Facts. Liss Co. was the Underwriter of the sale of (up to) \$50,000,000 Series I Collateral Trust Bonds issued by Arch Leasing Corporation Trust, pursuant to which sale a Prospectus dated 4/13/95 was to be delivered to each prospective purchaser. Liss Co. sold \$300,000 of the Bonds to the Estate of Virgil Adolph Guenther ("Estate" and "V.A. Guenther"). Mrs. Margadette M. Demet ("Mrs. Demet") was its Personal Representative. The Estate is a nominal claimant in that the Estate has distributed one-half of the Trust Bonds to each of the above-named claimants prior to bringing the instant claim. St. Louis Leasing Corporation ("St. Louis") was the Marketer. The Trust's business purpose to be effectuated by St. Louis was to purchase business equipment (largely computers) and to lease the equipment to well known (i.e., good credit) corporations. The proceeds of the Trust Bonds and bank loans would constitute 100% of the monies necessary to buy the equipment and pay the fees and costs of the offering, the commissions paid on the sale of the offering and the costs of acquiring the equipment and the leases except for 2% of Net Worth to be contributed by St. Louis the Marketer. There was to be

Philip P. Rummel, Esq. - Public Arbitrator  
Elise M. Neils, J.D. - Non-Public Arbitrator

**Concurring Arbitrators' Signatures**

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Thomas F. Mahoney, Esq.  
Public Arbitrator, Presiding Chair

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Signature Date

  
\_\_\_\_\_  
Elise M. Neils, J.D.  
Non-Public Arbitrator

1-31-02  
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a credit enhancement facility provided by an affiliate of Liss Co. called Red Oak (up to a maximum of \$1,000,000).

**Discussion.** The prospectus made it clear (or reasonably clear) that the success of the Arch Trust's business was in a material way contingent upon the viability and performance of St. Louis as the Marketer, who was required to come up with \$100,000 of original capital and additional capital to maintain the 2% Net Worth and was also the guarantor of the Credit enhancer Red Oak. St. Louis was to purchase the equipment, negotiate the leases and dispose of the equipment coming off lease. There was a general disclosure that the bankruptcy of St. Louis as Marketer could cause serious problems for the Trust. There was no explicit disclosure that the possible bankruptcy of St. Louis would also permit Red Oak to terminate its Credit enhancement. There was no explicit disclosure that since St. Louis was the only source of capital for the 2% Net Worth requirement, its bankruptcy could cause the offering to come to a halt because of inadequate capital or to become undercapitalized. There was no disclosure that the audited financials of St. Louis for the fiscal year ended March 31, 1994 showed that St. Louis had an "Accumulated Deficit" of \$4,066,000 and stated "The Company had an operating loss for the year ended March 31, 1994." (Liss Co. knew this fact since this financial statement was contained in an unrelated private offering which Liss Co. handled for an affiliate of St. Louis in March of 1995.) Additional inquiry would have shown that the audited financials of St. Louis for the fiscal year ended 3/31/92 showed "Retained earnings" to be a positive \$805,300. From this fact a reasonably competent observer (including this Arbitrator) would have concluded that St. Louis had operating losses of \$4,871,300 over the two years from 3/31/92 to 3/31/94. The evidence showed that Saint Louis had an operating loss—computed the same way as above—of \$2,892,000 during the fiscal year ending 3/31/95. While their 3/31/95 financials were not available prior to the April 13, 1995 Prospectus date, any interim financials for the first three quarters of fiscal 1995 would not have reassured one that St. Louis had turned profitable.

The failure to disclose in the Prospectus the materially large operating losses being incurred by St. Louis, and to link these losses to the possibility that St. Louis would file bankruptcy giving rise to the disclosed risks of bankruptcy, and to the possibility that Red Oak would permissibly terminate its up to \$1,000,000 Credit Enhancement, and to the possibility that St. Louis would no longer be able to contribute equity to maintain the 2% Net Worth as more Trust Bonds were sold and more bank loans taken out to purchase equipment, was a material omission, and constituted a violation of Liss Co.'s duties under Section 10B and Rule 10(b)5.

Evidence was received which showed that Jerome E. Liss (Mr. Liss) was the owner of Liss Co., the Designated Supervisor, and also Compliance Director of the office from which the Trust Bonds were sold and hence was the Control Person of Liss Co. Mr. Liss is hence found liable to the claimants to the same extent as Liss Co.

2. I concur with the majority of the Panel that Claimants did not prove their Second Claim relating to an alleged breach of fiduciary duty.

3. I dissent from the majority's holding that the claimants did not prove that the Respondents violated NASD conduct Rule 2300 (and specifically 2310) as set forth in the Third



Claim in Claimant's Statement of Claim. (The Third Claim referred to NYSE rules similar in purpose to Rule 2310. However, the Panel made it clear we would consider NASD Rule 2310 and not the inapplicable NYSE Rules [because Liss Co. was not a NYSE member] and evidence was offered on suitability by both Claimants and Respondents and argued by both sides in the closing argument.)

I hold that Claimants proved that Liss Co. violated the suitability provisions of NASD Rule 2310 and that if suitability had been properly evaluated that the Estate would not have been sold the Trust Bonds. The damages proximately caused were \$162,000 (one-half thereof to Ardell Guenther's guardianship estate and one-half thereof to the Virgil Guenther, Jr. Revocable Living Trust).

Evidence showed that Liss Financial Services Inc. is not an entity separate from J. E. Liss & Company and that Red Oak Financial not being a NASD member was not a subject of this arbitration.

**Facts.** The facts recited relative to Claim 1 above are restated here. The evidence shows the following additional facts. The \$300,000 in Trust Bonds sold to the Estate were subscribed to by Mrs. Demet, Personal Representative of the Estate, who was an attorney of long standing trust and estate experience on October 23<sup>rd</sup> of 1995. Mr. Liss saw the subscription documents and approved of the sale in his role as Designated Supervisor for the Liss Co. office in Milwaukee on behalf of Liss Co. The purchase was solicited by Michael Demet who was the son of Mrs. Demet. Michael Demet had for some years handled investments for his mother's IRA. When Michael Demet was at Prudential Securities, the Estate opened an account in April of 1994 and on April 13, 1994 deposited \$300,000 and purchased a \$299,994.72 interest in Prudential Utility Fund Class B. Mrs. Demet as Personal Representative signed a new account form listing income as #1 and safety as #2 and also confirmed to Prudential that as of April 13, 1994 the net worth of the Estate exclusive of residence was \$875,000, that the liquid net worth was \$875,000 and that the Estate had income of \$50,000 per annum. On or about August 18, 1994, Michael Demet transferred to Liss Co. and requested that the Estate make a bulk transfer which request stated *inter alia* that new account documents would not be required by Liss Co. The Estate approved the bulk transfer. The new account form at Liss Co. dated 8/25/94, signed only by Michael Demet, stated in large letters "Bulk Transfer" but contained no financial information and no information about the Investment Profile of the Estate. Liss Co. did not produce any other New Account Form for the Estate. I concluded that at the time of the Trust Bond subscription, October 23, 1995, Liss Co. had no written financial information about the Estate's net worth or investment objectives except what could be gleaned from the Estate's monthly statement showing as of 9/30/95 that the Estate's sole investment was a \$343,000 ownership of a Prudential Utility Fund. Its only other source of information was Michael Demet's recollection of the 4/13/94 Prudential New Account form information and what he had found out subsequently. Mr. Liss testified that he did not discuss the purchase of \$300,000 in Trust Bonds with Michael Demet when the Subscription Agreement crossed his desk and was approved by him. Therefore, any financial information, gleaned from whatever source, known by Michael Demet, was not known to Mr. Liss. Mr. Liss testified that from conversations he had with other brokers in his office he knew that Mrs. Demet was an attorney and had considerable experience

in trust and estate work. The Prospectus had as Exhibit A-2 thereof a disclosure that pursuant to the "Wisconsin Uniform Securities law" that each Wisconsin purchaser of Bonds must be "(a) a natural person...who had a gross income of at least \$45,000 during the previous calendar year...and is purchasing for his or her own account..." or "(b) a natural person who...has a net worth of at least \$150,000...and is purchasing for his or her own account..." or "(c) a bank, savings institution, credit union, trust company, insurer or savings and loan association acting for itself or as trustee with investment control." The other provisions, i.e., (d), (e), (f), (g) and (h), do not even remotely permit the sale of the Trust Bonds to an Estate. Exhibit A-2 to the Prospectus continues, "Each Wisconsin purchaser will be required to complete and execute a 'Wisconsin Suitability Certificate' stating that such investor meets at least one of the criteria set forth in the preceding paragraph." By its terms the Exhibit A-2 description of Wisconsin Securities law does not permit a sale to an Estate. The Wisconsin Suitability Certificate signed by Mrs. Demet as Personal Representative states, if the purchaser is an entity: "Estate of Virgil A. Guenther." Mrs. Demet certified by placing an "X" in the box where the printing on the Certificate states, "I (either individually or with my spouse) have a net worth of at least \$150,000 (exclusive of my [our] principal residence and its furnishings and personal use automobile) and am purchasing units for my (our) own account or for my (our) retirement plan or trust." Mrs. Demet hand wrote the following statement above the X'd written language quoted above: "The estate has a net worth of at least \$150,000."

Claimants made no separate claim for liability against Liss Co. for a violation of the Wisconsin Securities Act. However, Counsel for Claimant in his closing argument cited to the Panel the fact that the Wisconsin Suitability Certificate did not by its terms permit sales to Estates.

The "Operation and Compliance Procedures of J. E. Liss and Company, Inc." ("Manual") states inter alia:

- (1) "Currently the Firm's Designated Supervisor is Jerome E. Liss...the ultimate responsibility for ensuring the Firm complies with federal and state securities laws, and the regulations of the NASD governing the securities activities of the Firm and its Representatives, rest with the Designated Supervisor." (Section 1.1)

- (2) "3.3 Books and Records and Retention Requirement.

The Firm is required to prepare, maintain and preserve various...records under the regulations and rules of the SEC, NASD and states. A summary of the key records follows:

- (c) New Account Form

New account forms reflecting each customer's annual income, net worth and investment objectives shall be maintained."

(3) "3.7 Prohibited Business Practices by the Firm

The Firm shall not engage in the following practices while conducting its securities business:

- (c) Recommend to a customer the purchase, sale or exchange of any securities not suited to the customer's financial situation and needs...
- (e) Violate any rule of any national securities association of which the Firm is a member with respect to any investor, transaction or any securities business activity.
- (i) Purchase or sell any security while in possession of material information that is not available to the general public..."

The Prospectus dated 4/13/95 stated as one of its Risks at page 12, "17. Bonds are an Illiquid Investment. There is no public market for the Bonds, and no assurance can be given that such a market will be developed or, if developed, maintained. Therefore, Bondholders may not be able to liquidate their investment in the Bonds in the event of an emergency or for any other reason."

As of the end of October 1995, no public market for the Bonds had been developed.

Other material disclosures in the Prospectus's Risk Factors Section: (1) made it clear that the ultimate ability to repay the Trust bonds depended on the market prices of the used equipment when it came off lease 36 to 42 months after April 1995; (2) made it clear that the Trust Bonds would be a junior lien (second mortgage) to the bank loans taken out to purchase the equipment together with the net proceeds of the Trust Bonds. At p. 9, "7 Subordinations of Lien," "The Trust currently intends to finance the purchase of approximately 85% of its Equipment with Senior Debt;" and (3) made it clear that the assets of the Trust were limited. At p. 10, "13 Limited Assets, the Trust does not have, nor is it permitted or expected to have, any significant assets or sources of funds other than the Equipment, the Leases and the Trust Accounts."

On April 24, 1995 (after the Prospectus date but before the Sale to the Estate), the CEO of St. Louis, Robert A. Chlebowski ("Mr. Chlebowski"), wrote to All Employees, cc to Jerry Liss, and stated *inter alia*, "That means it will have been more than a month since we received any investor dollars from our leasing programs. When you consider that we have been receiving between \$1.5-\$2.0 million per month from this source, it is obvious that we are cash strapped."

On May 15, 1995, Mr. Chlebowski again wrote to All Employees, cc Jerry Liss, Re: Trust Bond Update, and states *inter alia*: "We expect that Tuesday, May 16, 1995 will be the date we break the escrow" (of the proceeds of the sale of the Trust Bonds)... "I know the road we have traveled has not been easy, but the long-term success of SLC (St. Louis) depends upon this product."

On June 2, 1995, Mr. Chlebowski again wrote to All Employees, cc Jerry Liss, and stated *inter alia*:

WEEK OF	PLANNED ARCH SALES	CUMULATIVE PLANNED SALES	ACTUAL ARCH SALES	CUMULATIVE ACTUAL SALES	(+) OR (-) PLAN
May 29, 1995	\$575,000	\$5,175,000	\$1,082,000	\$2,613,000	(\$2,562,000)

On October 16, 1995, Mr. Chlebowski wrote a Memo to Mr. Liss, Subject: Arch Participation Cash Flow.

(The Memo discussed the then current cash flow situation of the many Arch Fund Private Placements, all of which had been privately sold by Liss Co. as primary sales agent.) The memo states *inter alia*... "Both the month-to-month leases and the returned for sale or release cause SLC cash flow problems in making the Arch Participation Payments (N.B. Not the Trust Bond interest payments). For example, if we get back 200 notebook computers with \$500 each or \$100,000 total, it will take us about 90 days to see that inventory. In the meantime, the investor needs his principal. If SLC had the working capital it could buy those notebooks from the investors and take its time selling the computers over a 90-day period.

To meet our obligations to investors in the next year, we will need to sell a month-to-month package of \$1.2-\$1.5 million every other month. (I believe this refers to a needed sale of the Trust Bonds.)

A million dollar credit line for inventory would also allow SLL (St. Louis) the luxury of buying inventory from an Arch Participation for later sale or release."

The unaudited financials of St. Louis dated March 31, 1995 had a date of September 18, 1995 for the auditors to sign. The financial statement revealed the following: that the "accumulated deficit was (\$6,958,000)." When compared to the 3/31/94 accumulated deficit of (\$4,066,000) one can infer that St. Louis incurred an operating loss of \$2,892,000 in the fiscal year ending 3/31/95. The 3/31/95 financial statement stated *inter alia* in Note 7 Shareholders Equity, "The Company had an operating loss for the year ended March 31, 1995."

There was no evidence presented Mr. Liss had a copy of this financial statement on or before October 23, 1995.

On November 11, 1995, Mr. Chlebowski on behalf of Saint Louis wrote to Dear Broker-Dealer (including Liss Co.) and stated that effective on November 15, 1995 the Trust will cease offering bonds for sale. "This action was taken after the board of directors of St. Louis Leasing Corporation (SLL) and Arch Leasing Corporation (ALC) met on November 14, 1995 to review the operations of the Trust. Because the reserve requirement needed by the Trust left the operations of the business (SLL-ALC) with too little income to meet its expenses and because the

coupon rate of the bond (10.5%) was too expensive for market conditions making SLC's lease rates uncompetitive, this difficult decision was made. The Trust has adequate assets and reserves to meet its outstanding obligations terminating the sale of bonds forces SLC to exit the new lease origination business. Effective November 16, 1995, SLL and ALC have reduced their staffs to a minimum number of employees necessary to 'wind-down' the lease portfolio over the next three years."

Mr. Michael Demet testified that he solicited his mother, Mrs. Demet, as the Personal Representative of the Estate to purchase \$300,000 of Trust Bonds, gave her the Prospectus and explained to her his understanding of the investment with special emphasis on its safety. He testified that he had never seen St. Louis financials for the fiscal year 3/31/94, 3/31/95 or any earlier years and that he had never been told about any financial problems which St. Louis suffered either as revealed by its financial statements or from any of the Memos received by Mr. Liss. Mr. Michael Demet testified that he had one or more conversations with Mr. Liss about the Trust Bonds, first in connection with a previous solicited sale of \$45,000 thereof to his mother, Mrs. Demet, as Trustee of the Revocable Trust of Anita Walsh on May 19, 1995, and probably again in connection with the solicited sale to the Estate of Virgil Guenther.

Mrs. Demet testified that no one from Liss Co. had told her about the financial situation of St. Louis nor did she know about it prior to learning of its Chapter 11 bankruptcy after such was filed on or about January 4, 1996.

Michael Demet testified that Mr. Liss told him and he told his mother, Mrs. Demet, for sure before the Anita Walsh Purchase and probably before the Estate purchase that Mr. Liss mentioned to him as a safety feature the Credit Enhancement of Red Oak, a firm owned by Mr. Liss. Mr. Liss denied having this conversation(s) and asserted that the Red Oak Credit Enhancement provisions were fully disclosed in the Prospectus, including specifically the conditions under which Red Oak's commitment could be terminated. The evidence shows that the Red Oak Credit Enhancement undertaking was terminated pursuant to the terms of the Credit Agreement on August 15, 1996, citing the bankruptcy of the Marketer (St. Louis) "and the inability of the Marketer to provide the guarantee..." If Red Oak had advanced Funds to the Trust, St. Louis guaranteed that Red Oak would be repaid and with the bankruptcy of St. Louis this Guarantee was defacto (if not de jure) terminated.

Michael Demet was not named as a Respondent in this Arbitration. Mrs. Demet testified that she understood that a bond yielding 10-1/2% was riskier than a money market fund yielding 5%. She testified that she sought to earn income for the benefit of the Estate's beneficiaries. Mrs. Demet testified that there were two beneficiaries of the Estate, each to one-half. Ardell Guenther (son of V. A. Guenther) was a 40-plus-year-old developmentally disabled adult who owned no physical or liquid assets other than his one-half ownership of the Estate. Ardell had no income except a small disability payment. Prior to the death of V.A. Guenther, his father had supported him. The other beneficiary was Virgil Guenther, Jr. (Virgil, Jr.), the other son of V.A. Guenther. Virgil, Jr. was a 40-plus-year-old single man who had a good blue-collar job but no assets other than his personal residence and his one-half interest in the Estate.

Michael Demet testified that his mother was intelligent but was not an investment whiz and that she relied upon professional advisors.

Mrs. Demet testified that the bulk of her personal investments was in real estate, that her experience with bonds was minimal, that she relies on professional advisors and that in addition to reading the Prospectus she relied on representations from Michael Demet in connection with the purchase of the Trust Bonds.

Mrs. Demet testified that she had conferred with Virgil (who had no investment experience) prior to causing the Estate to purchase the \$300,000 of Trust Bonds.

On September 30, 1995, the Estate's Securities Account at Liss Co. showed a value of \$343,174.06, consisting of a Prudential Utility Fund Class B investment valued at \$343,124.78, and \$49 in a Prudential money market fund yielding 5.29%.

On October 31, 1995, the Estate's Securities account at Liss Co. showed a value of \$30,113.43, all in cash or money market funds. During the month the account showed that the Prudential Utility Fund Class B was sold on 10/25 for a net amount of \$330,050.50 and that a check for \$300,000 was issued. The \$300,000 was used to purchase the Trust Bonds.

There was testimony by both Mrs. Demet and Mr. Liss that Prudential, Liss Co.'s clearing firm would not hold the Trust Bonds in one of Liss Co.'s customer's accounts.

Mrs. Demet testified that between April 13, 1994 when the Estate had liquid assets of \$875,000 and the end of October of 1995 that the net liquid assets of the Estate were substantially lower because of three factors: (a) monies had to be expended for the care of Ardell in excess of his disability income, (b) the Estate had paid or provided for the payment thereof of "considerable" Federal Estate Tax on the value of the Estate in excess of \$600,000, (c) at the request of Virgil Jr. the Estate, which owned two pieces of residential real estate in very bad shape (valued at \$20,000 apiece), had spent considerable monies on rehabilitating these properties. Ardell resided in one and the other, a duplex, was rented out after the cost of restoration.

The exact amount of the liquid value of the Estate late mid-October of 1995 was not placed in evidence.

Respondent offered (and it was received in evidence) an opinion by The Honorable Michael Malmstadt, Milwaukee County Circuit Court, Branch 39, dated November 30, 2001 in David Roesler et al. vs. J.E. Liss & Company Inc. et al., Case No. 99 CV-5197.

Judge Malmstadt found, in a case involving the Trust Bonds with many similarities to the instant arbitration, that the plaintiffs were not entitled to their relief and their claims were dismissed. (This included their claim against Liss Co. and the broker Butenhoff who sold them the Trust Bonds.)

There are both similarities and differences to the instant arbitration.

### **Similarities**

1. Defendant Butenhoff, the broker, was the brother-in-law of Harding (who recommended the Trust Bonds to the Yamines).
2. The Yamines received a Prospectus and a Subscription Agreement and on June 12, 1995 they signed the Subscription Agreement and sent a check for \$400,000.
3. It was clear from the evidence adduced that the success of the investment was contingent upon the success of marketing the releasing or sale of the computers (by St. Louis) after the term of the original leases.
4. It was clear that the defendants acknowledged the Trust Bonds were a secondary interest in the computers.
5. The Judge found the Yamines were aware that the higher the interest rate on a bond the higher was the risk.
6. The Yamines contended *inter alia* that Liss Co. violated the "know your customers rule" and the requirement of suitability.
7. There was no New Account Form for the Yamines in the Liss Co. records.

### **Possible Similarity**

The Yamines contended that some or all of defendants Liss Co., Butenhoff, Schimpf (another Liss Co. broker) and Mr. Chlebowsky conspired not to disclose certain facts to the Yamines prior to signing the June 12, 1995 Subscription Agreement. The Judge stated the questions of soundness of the Trust Bond . . . "included the falling value of used computers beginning in early 1995; claimed cash flow problems at St. Louis Leasing during the inception of the 'Arch Bond' investment program; Robert Chlebowsky's personal finances and monies he received from St. Louis Leasing; the value of the Red Oak Financial guarantee to investors in the 'Arch Bond' program; the lack of depth of the management structure of St. Louis Leasing."

The Judge found that there was no evidence that the defendants conspired among themselves or others to conceal negative information related to the Trust Bonds. The Judge further stated that the Yamines could not prevail absent evidence that "some defendant was aware that at least one of these issues did negatively affect the safety of the investment. The state of the record with respect to these issues merely raises questions. It does not satisfy this court by the preponderance of the evidence, let alone by evidence that is clear, satisfactory and convincing that the defendants or any one of them, intentionally misrepresented any material fact to the Yamines" at p. 8.

### **Dissimilarities**

1. The Yamine family was in the home building business, generally building two homes

a year which were designed by Mrs. Yamine and constructed by Mr. Yamine as general contractor.

2. The Yamine family relied on their accountant Harding's knowledge of the previous Privately Placed Arch Fund investments (sponsored by St. Louis and sold by Liss Co.) and based on his knowledge about the Trust Bonds. The court found at p. 5 that "It is clear to the court that the sole reason the Yamines decided to invest in the 'Arch Bonds' was the fact that their accountant, Leon Harding recommended it to them."

3. The Yamines had a net worth in excess of one million dollars.

4. The Yamines had a high tolerance for risk. At p. 6 the Judge states "Their involvement in the business of building high-end homes for ultimate sale to buyers yet to be determined at the time of construction shows that they were willing to accept a relatively high level of risk in their financial life."

5. The purchase by the Yamines was unsolicited by any of the defendants, i.e., no one at Liss Co. recommended that the Yamines purchase the Trust Bonds.

6. The court found that . . . "the testimony of Paul Littau, which the court determines to be credible based on his experience in the field, establishes the rule related to 'suitability' and the 'know your customer' rule do not apply to unsolicited transactions." (P. 8)

7. The court further found at p. 9 that "The Yamines were clearly suitable for the investment based on their net worth. Therefore, any claimed violation of the 'suitability' rule did not cause injury to them."

8. The court further found that the investment did not exceed "... any risk level the Yamines may have communicated to the defendants had the defendants made such an inquiry in compliance with the 'know your customer' rule."

### **Discussion**

NASD Conduct Rule 2310 requires that before a transaction is recommended to a non-institutional customer, the member (i.e. Liss Co.) shall make reasonable efforts to obtain the customer's financial status and the customer's investment objectives. In making such a recommendation after obtaining the information for a customer to purchase a security, the member shall have reasonable grounds for believing that the recommendation is suitable. Liss Co.'s own Manual also required the recommendation to purchase to be suited to the customer's financial situation and needs, and Liss Co.'s own Manual required the obtaining and holding of a New Account form reflecting each customer's annual income, net worth and investment objectives.

Liss Co. cannot be excused from considering suitability because Liss Co., acting through its Designated Supervisor, did not get a New Account form, did not contact Mrs. Demet, the representative of the Estate, and did not by Mr. Liss's testimony even talk to Michael Demet, the



soliciting broker, about his understanding of the income, net worth and financial objectives of the Estate or of the beneficiaries thereof or about his reason(s) for believing the Trust Bond was suitable for the Estate and the beneficiaries of the Estate.

Further, NASD Rule 2310-2 relating to Fair Dealing with customers states that Members are responsible for fair dealing with customers. The first example given of violation of fair dealing is "Recommending speculative low-priced securities to customers without knowledge of or attempt to obtain information concerning the customers' other securities holdings, their financial situation and other necessary data." While the Trust Bonds were clearly not a low priced security, they were clearly very risky and Mr. Liss made no attempt to find out the required information since he did not have a New Account form, did not discuss the account with Michael Demet, the soliciting broker, and had no other knowledge about the financial characteristics of the Estate or who the beneficiaries thereof were and what their finances were. I believe that Liss Co.'s omissions also breached its duty of Fair Dealing under 2310-2.

The real customers here were Ardell and Virgil.

The Wisconsin Securities Act did not permit a sale to an Estate.

Regardless of who one thinks is the customer; Ardell and Virgil or the Estate of which they are the sole beneficiaries, the facts are that Liss Co. solicited the purchase of \$300,000 of Trust Bonds from a customer about whom the Designated Supervisor had no knowledge except that the Estate had an account with Liss Co. worth \$343,000 on September 30 consisting of a position in a Prudential Public Utility Fund (clearly, an investment with both income and safety). Liss Co. knew that the Estate had sold the Public Utility Fund to invest \$300,000 of the proceeds thereof in a Trust Bond which was not publicly traded and was not likely to be publicly traded. (Mr. Liss knew that the Bonds were cleared for sale in April of 1995 but that by late October the Bonds had not become publicly traded.) For all Mr. Liss knew, the entire liquid assets of the Estate were the \$343,000 figure.

One of the most important rules of investing is that a particular investment should not be overly concentrated relative to the size of the account (or if the NASD member has knowledge thereof, relative to the customer's entire portfolio). An account with \$343,000 should not concentrate \$300,000 thereof in one investment. When this \$300,000 investment is a Trust Bond with the risks described herein, which cannot even be sold if the owner thereof needs liquidity or desires to cut the owner's losses in a deteriorating situation before the bond defaults, the over-concentration of this Trust Bond position is a clear violation of its suitability (for either the Estate or the beneficiaries thereof) in addition to all the other violations of suitability relating to the sale of the \$300,000 of Trust Bonds to the Estate (or to the beneficiaries thereof).

Mr. Liss knew all the risks disclosed in the Prospectus including especially the fact that the Trust Bond was a junior lien standing behind 85% (of the purchase price of the collateral) in bank loan liens and that it depended upon the value of used computers to give the Trust Bond holders any chance of getting back all their money. Mr. Liss knew of the importance of St. Louis Leasing as the Marketer in purchasing the equipment, negotiating the leases and in the sale of the

equipment at the end, and that St. Louis was the entity required to contribute the 2% of Net Worth and was the guarantor of Red Oak, his wholly owned company, which granted the Credit Enhancement.

Even if Liss Co. did not have a duty to disclose in the Prospectus the financial situation of St. Louis revealed in the March 31, 1994 financials and hence did not violate Rule 10(b)-5, Mr. Liss knew about these financials and about St. Louis's serious cash flow problems revealed by memos to him in the April 24, 1995 through October 16, 1995 period and Mr. Liss knew or ought to have known about the large operating loss for St. Louis in the fiscal year ending March 31, 1995. This financial statement has a date of September 18, 1995 and with the closeness of Mr. Liss and his firm to St. Louis in that Liss Co. had sold St. Louis's Preferred Stock, had sold St. Louis's Convertible Bond, had sold many Private Placements sponsored by St. Louis, and was selling the Trust Bonds, I believe that it was likely that Mr. Liss had seen the September 18, 1995 St. Louis financials or at least had heard of the continued Net Operating Loss. In the alternative, he had a duty to have obtained and reviewed the March 31, 1995 financial statement before approving the recommendation of the sale of the Trust Bonds to the Estate and its beneficiaries on or about October 23, 1995. Liss Co. was required by its own Manual not to sell any securities while it was in the possession of material information that was not available to the general public. Three weeks after the 10/23/95 sale of \$300,000 of Trust Bonds to the Estate, the entire offering was terminated because St. Louis could no longer come up with the cash to maintain the 2% Net Worth required by the undertaking disclosed in the Prospectus.

Even if Liss Co. had no duty to amend the Prospectus, such knowledge about St. Louis's deteriorating financial situation between April 13, 1995 and the end of October 1995 should have made Mr. Liss even more cautious in approving the sale of an over-concentrated \$300,000, illiquid (no public market), second lien bond standing behind 85% of bank loans on computer equipment collateral to an Estate, and therefore to its beneficiaries, where as far as he knew the total assets and the liquid assets thereof did not exceed \$343,000. If Mr. Liss had known what the actual size of the Estate was and who the beneficiaries thereof were, he would have found that one of the beneficiaries was Ardell Guenther, whose financial situation (net worth) and inability to ever earn any money from employment would have required only safe income related investments like the Prudential Utility Fund and for whom the Trust Bonds were about as unsuitable as unsuitability can get.

Mr. Liss also permitted the sale to proceed when he knew or ought to have known from reading the Wisconsin Suitability Certificate and from Exhibit A-2 to the Prospectus, on which Liss Co. was the Underwriter, that a sale to an Estate was not permitted under Wisconsin securities law. Certainly a sale not permitted by the securities law of the state where both the broker dealer and the customer resides also should have caused Mr. Liss not to approve the sale. This is even more important when taken together with the other above-described breaches of NASD Rule 2310 and 2310-2 (and even of Liss Co.'s own requirement that the Firm not recommend to a customer the purchase of a security not suited to the customer's financial situation and needs).

In his closing argument, counsel for the Respondents argued, based on his interpretation of evidence admitted in the hearing, that a reason for the sale may have been to see to it that Michael Demet received a large commission (it was clear he was not a large producer of commissions) by a mother (Mrs. Demet) who was concerned for him and thought more of getting him a large commission than she did about her fiduciary duty to put appropriate investments into the Estate. Mrs. Demet denied that this was her motivation and stated that she did not know the amount of Michael Demet's commission income generally and did not know the amount of his commission on the sale of the Trust Bonds to the Estate. (The evidence showed \$12,000.) The possibility that Michael Demet may have solicited a purchase by an Estate of the Trust Bonds while himself ignoring its suitability, relying on the good will of his mother who as Personal Representative of an Estate was not investing her own money, so as to give him a large commission, should not excuse Mr. Liss on behalf of Liss Co. from pursuing the requirement on behalf of Liss Co. to review the purchase for suitability under Wisconsin law, the NASD Rules and Liss Co.'s own rules. Rather, the mother/son relationship should have made Mr. Liss even more careful in his review, not less careful; and in any event, even if the "fact" of the possibility were true, it would not excuse Liss Co. from its responsibilities as a Member of NASD.

Also carefully read, Judge Malmstadt's opinion in the Roesler case does not tend to show that violation of the suitability rules should not be found in the instant arbitration.

Both the NASD 2310 Rules and the Liss Co. rule state that suitability should be a consideration when a broker/dealer recommends the purchase of a security. In the Guenther arbitration, Liss Co. recommended that the Estate purchase the Trust Bonds. Judge Malmstadt found that suitability did not apply in the Roesler case because Liss Co. did not recommend the purchase of Trust Bonds to the Yamines. In the Roesler case, Judge Malmstadt found that the Yamines were not unsuccessful in their business, had a net worth in excess of \$1,000,000, and had an appetite for risk at least equal to the risk Judge Malmstadt found to exist in the Trust Bonds; so that even if suitability had applied, he found the Yamines to be suitable. In the Guenther arbitration, the net worth of the Estate was less than \$875,000. Also, as Mrs. Demet testified, the liquid assets in the Estate as of October 23, 1995 were considerably reduced from the \$875,000 amount as of April 13, 1994 for the reasons set forth in the facts above.

Judge Malmstadt did state at p. 9 "Furthermore if these obligations did apply (referring to the "suitability" and "know your customer" rules) the failure to comply may be negligence per se, (emphasis added) but that negligence in this instance, is not causal."

I infer that had Judge Malmstadt found that "suitability" and "know your customer" did apply because the Yamines' purchase was recommended (solicited) and if he had found that the Yamines' net worth was not large enough for the investment to be suitable and that Yamines' tolerance for risk was not high, e.g. they had a desire for safety, he would have found that the failure of Liss Co. to comply with the rules was "negligence per se."

It is my opinion that the Claimants proved that Liss Co. violated the suitability rules cited above in the sale of the Trust Bonds to the Estate for the benefit of Ardell and Virgil Jr. not by a preponderance, not by clear and convincing not beyond a reasonable doubt, but beyond a shadow

of a doubt.

I do not believe that the Panel is permitted to find Mr. Liss also liable for the breach of suitability of Liss Co. He took his actions and made his omissions as an agent of Liss Co., and it is Liss Co.'s duty as a member of NASD to enforce NASD's suitability rules. So I concur with the majority that Mr. Liss is not personally liable under the Third Claim.

4. I concur with the majority that the Claimants did not prove the Respondents were liable for intentionally making false and fraudulent statements under the rules of common law fraud.

I do not believe that a separate cause of action exists for negligent representations in that the 10b-5 violation requires at least reckless behavior and the common law fraud requires intentional behavior, and so I concur with the majority that Claimants did not prove the negligent misrepresentation count.

5. I concur with the majority that the Claimants did not prove that the Respondents were liable under the Fifth Claim.

6. Paragraph 47 of the Statement of Claim requests punitive damages. The majority finding no liability on the part of Respondents did not reach this claim. I believe that while the distance between what Liss Co. should have done and what it actually did in performing its duties under suitability was very wide, that no punitive damages should be awarded.

#### **Respondents' Affirmative Defenses**

- A. Mrs. Demet (Kevin Demet, now fiduciary to Virgil Jr., was not involved with the purchase of the Trust Bonds and hence should not be included in this Defense) was the fiduciary to the Estate and as such was responsible for purchasing appropriate investments for the Estate. However, even if she failed to meet her fiduciary duty, to the Estate, or to the beneficiaries thereof, such failure is not a defense to a violation of Rule 10(b)-5 by Respondent Liss & Co., nor is such failure a defense to a massive failure by Liss Co. to observe both the Wisconsin Securities Act Suitability, the NASD suitability rules and Liss Co.'s own internal suitability rules.
- B. Mr. Liss made no direct statement(s) to Mrs. Demet. My opinion on two Counts, I Rule 10(b)-5 and III, Suitability, do not rely on any statements allegedly made by Mr. Liss. Therefore, Affirmative Defense B is not a relevant defense to either Claims I or III.
- C. I find that Affirmative Defense C is not a valid defense and that Respondents did not prove it either.
- D. Respondents state "Claimants have contributory fault because their agents, Mrs. Demet and Kevin Demet, have failed to advise them about the published risks associated with the Trust Bonds." (Kevin Demet was not involved in any way with the Trust Bond purchase.) For the reasons stated above relating to Affirmative Defense A, any failure of

Mrs. Demet to advise Ardell and Virgil Jr. about the "published risks" is not a defense to either a Rule 10(b)-5 violation or a suitability violation. N.B. It is clear from reading Respondents' Affirmative Defense D that Respondents now argue that the real customers at the time of the sale of \$300,000 of Trust Bonds to the Estate through Mrs. Demet were Ardell Guenther, a developmentally disabled adult, and Virgil Guenther Jr., a blue collar working man, as they seek to hold them with "contributory fault" in connection with the "published risks" in the Prospectus associated with the sale of the Trust Bonds, alleging that their agent, Mrs. Demet, failed to advise them about the published risks.

- B. The one Statute of Limitation which was relevant to a claim on which I found liability was on the 10(b)-5 claim. I found that Respondents had not proved that the claim was not brought within one year of its discovery.
7. I agree with the Majority's holding that Red Oak was not properly before the Panel.
8. I agree with the majority in our jointly decided allocation of forum fees.

Dissenting Arbitrator's Signature

Philip P. Rummel  
Philip P. Rummel, Esq.  
Signature Date  
Public Arbitrator

February 6, 2002

2/12/02 NGA  
Date of Service (For NASD-Dispute Resolution office use only)