

AWARD
NASD Dispute Resolution

In the Matter of the Arbitration Between

Claimants

John L. Sherman and Jean A. Sherman

v.

02-06703
Denver, Colorado

Respondents

Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc.
Gregory A. Adams, Steven E. Muth, and
Mutual of Omaha Insurance Company

and

Cross-Claimant/Counter-Respondent

Steven E. Muth

v.

Cross-Respondent/Counter-Claimant

Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc.

Nature of Dispute: Customers v. Member, Associated Persons and Non-Member; Associated
Person v. Member; and Member v. Associated Person

REPRESENTATION OF PARTIES

John L. Sherman and Jean A. Sherman ("Claimants") were represented by D. Elizabeth Wills, Esq., of Rothgerber Johnson & Lyons, LLP, Denver, Colorado.

Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc. ("KPS") and Gregory A. Adams ("Adams") were represented by John V. McDermott, Esq., and Randall H. Miller, Esq., of Holme Roberts & Owen, LLP, Denver, Colorado.

Steven E. Muth ("Muth") was represented by Matthew M. Wolf, Esq., of Allen & Vellone, P.C., Denver, Colorado until his Notice of Withdrawal was filed on or about November 7, 2003. Muth was later represented by Steven M. Feder, Esq., of the Feder Law Firm, Denver, Colorado, until his Notice of Withdrawal was filed on or about March 5, 2004, after which Respondent Muth appeared pro se.

Mutual of Omaha Insurance Company ("Mutual of Omaha") did not appear.

CASE INFORMATION

The Statement of Claim was filed on or about November 5, 2002. The Submission Agreement of Claimants was signed on or about October 30, 2002.

A Statement of Answer was filed jointly by Respondents, Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc. and Gregory A. Adams, on or about January 13, 2003. The Submission Agreement of Respondent, Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc., was signed on or about February 2, 2004, by Kent J. Lund, Executive Vice-President and General Counsel of Kirkpatrick, Pettis, Smith, Polian, Inc. Respondent Gregory A. Adams did not file a Uniform Submission Agreement.

A Statement of Answer was filed by Respondent, Steven E. Muth, on or about January 16, 2003. The Submission Agreement of Respondent, Steven E. Muth, was signed on or about March 4, 2003.

Mutual of Omaha Insurance Company did not file a Statement of Answer or Uniform Submission Agreement.

Steven E. Muth filed a Cross Claim on or about February 7, 2003. KPS filed an Answer to the Cross Claim on or about March 27, 2003. Muth filed a Motion for Leave to Amend his Cross Claim on or about May 12, 2003. KPS filed a Response to the Motion for Leave on or about July 14, 2003. Muth filed an Amended Cross Claim on or about May 27, 2003.

Respondent, KPS, filed a Counterclaim on or about March 1, 2004.

Respondents, KPS and Adams, filed a Motion to Dismiss on or about December 1, 2003. Muth filed a Response in Opposition on or about December 11, 2003.

KPS filed a Motion for Summary Judgment on or about March 1, 2004. Muth filed a Response to KPS' Motion for Summary Judgment on or about March 22, 2004. KPS filed a Reply in Support of its Motion for Summary Judgment on or about April 9, 2004.

Muth filed a Motion for Summary Judgment on or about March 22, 2004. KPS filed an Opposition on or about April 2, 2004.

CASE SUMMARY

Claimants asserted causes of action including the following: breach of fiduciary duty; violations of the Colorado Securities Act; control person liability; common law fraud, negligence; and breach of contract. The causes of action related to Claimants' allegation that Respondents engaged in the manipulation of the market in regard to three NASDAQ Small-Cap companies: Creative Host Services ("CHST"), BONSO Electronic, Inc. ("BONSO") and Colonial Commercial Corporation

("CCOMP"). Claimants asserted that Muth manipulated the market by investing all of his clients in as much BONSO and CHST as he could and that he solicited his clients to open margin accounts to purchase additional holdings in these companies. Claimants alleged that Muth had personal knowledge that another of his clients owned over 40% of the outstanding shares of CHST, and over 10% of BONSO outstanding shares, and that this client was precluded under Section 16(a) of the Securities Exchange Act of 1934 from selling any of the CHST or BONSO holdings. Claimants asserted that because of this hold, Muth was able to invest all of his customers on margin in these stocks, while Muth and his friends sold their own shares into the market demand that Muth falsely created in order to stabilize the sale price. Claimants stated that because KPS failed to supervise the actions of Muth and failed to diversify their accounts KPS should be held liable under respondeat superior.

Respondents, KPS and Adams, denied the allegations set forth in the Statement of Claim and asserted defenses including the following: Claimants failed to mitigate their damages; Claimants voluntarily and knowingly assumed all risk related to their stock purchases; Claimants failed to plead factually any scienter or the requisite state of mind with particularity; Claimants have not alleged and cannot prove loss causation; some or all of Claimants' claims are barred by the applicable statute of limitations; Claimants failed to state a claim upon which relief can be granted; and to the extent that any current or former employees of KPS, including Muth, acted outside of the scope of that employment or without actual authority from KPS, KPS has no liability to the Claimants.

Respondent Muth denied the allegations set forth in the Statement of Claim and asserted various defenses.

Muth, in his Cross Claim, asserted causes of action including the following: fraud and violation of NASD and SRO rules and regulations; misrepresentations; omissions; breach of fiduciary duty; breach of the duty of due care, fair dealing, good faith and proper guidance; negligence; breach of contract and quasi contract; promissory estoppel; fraud; respondeat superior; and manipulation of the market. Muth alleged that KPS supported his trading strategy for his clients that would maintain a larger amount of shares in a limited number of companies to maximize profits. Muth stated that before he transferred his book of business to KPS, both parties agreed that Muth would be able to have a 50% margin ratio for his clients to invest in these companies. Muth alleged that KPS, without warning, raised his customer margin rates to 90%, which forced them to sell their holdings to cover their margin calls. Muth further alleged that KPS later ceased all trading in CHST and BONSO and canceled all buy orders for these securities causing losses to his customers and to his personal holdings in these companies, which Muth alleged was an attempt by KPS to manipulate the market for financial gain.

KPS denied the allegations set forth in the Cross Claim and asserted defenses including the following: all of Muth's claims are barred by the applicable statute(s) of limitations; Muth failed to state a claim upon which relief can be granted; Muth failed to mitigate his damages, if any; Muth failed to plead factually any scienter or the requisite state of mind with particularity; KPS made no

actionable misrepresentations; Muth acted outside the scope of his employment and without actual inherent or apparent authority from KPS; Muth acted contrary to applicable securities laws, rules, regulations, and in contrary to KPS' policies and procedures; and Muth's claims are barred by the doctrines of unclean hands and *in pari delicto*.

KPS, in its Counterclaim, asserted causes of action including the following: breach of fiduciary duty; breach of contract; fraud; tortious interference; constructive fraud; intentional destruction of KPS' business reputation and indemnification. KPS alleged that Muth devised and executed a plan to manipulate stock prices while employed at KPS and that Muth's conduct was outside, and contrary to, his obligations, duties, and responsibilities as a KPS employee. KPS asserted that Muth concealed and/or misled KPS' officers, employees, directors and clients about his motives and conduct. KPS further alleged that as a result of Muth's misconduct, it has suffered substantial damages to its reputation.

RELIEF REQUESTED

Claimants requested an award of \$108,056 in compensatory damages, plus rescissory damages of \$298,092, a disgorgement of all commissions and fees associated with their accounts, interest, attorneys' fees, punitive damages, costs, and any other relief the panel deemed appropriate.

Respondents, KPS and Adams, requested that the claims asserted against them be denied in their entirety and that they be awarded their costs and attorneys' fees. In KPS' Counterclaim, it requested an Award of \$30,000,000 in compensatory damages, plus punitive damages, pre- and post-judgment interest, attorneys' fees, costs, and any other relief the panel deemed appropriate. In addition, KPS requested the panel award \$154,231.04, in damages, due to the default of a compensation agreement between KPS and Muth dated March 15, 2000, plus interest and all costs of collection relating to the default. At the arbitration hearing, KPS amended that damages to \$28,257,822 in compensatory damages, plus \$234,289, for the breach of contract, punitive damages, any and all costs of the proceeding and such other relief as the Panel deemed just and proper.

Respondent, Muth, requested that the claims asserted against him be denied in their entirety and that he be awarded his costs and attorneys' fees. In Muth's Cross Claim, he requested an Award of \$50,000,000 in compensatory damages, plus punitive damages, interest, costs, attorneys' fees and any other relief the panel deemed just and proper. In his Amended Statement of Cross Claim, Muth decreased the amount of compensatory damages requested to \$9,000,000.

OTHER ISSUES CONSIDERED & DECIDED

Respondent, Mutual of Omaha Insurance Company, is not a Member of NASD. Mutual of Omaha Insurance Company did not voluntarily submit to NASD arbitration, nor was a contract to arbitrate disputes with Mutual of Omaha Insurance Company presented. Therefore, Mutual of Omaha Insurance Company is not compelled by NASD rules to arbitrate disputes in this forum. In the

absence of Mutual of Omaha Insurance Company's voluntary submission, NASD does not have jurisdiction over this party.

On or about May 5, 2003, Claimants dismissed all claims asserted against Respondents, Kirkpatrick, Pettis, Smith, Polian, Inc. and Gregory A. Adams, with prejudice and dismissed their claims asserted against Respondent, Steve E. Muth, with prejudice.

On or about February 9, 2004, the panel granted the Motion for Leave to Amend Muth's Cross Claim and granted KPS' request to file a response and/or Counterclaim in this matter on or before March 1, 2004. At the pre-hearing, Respondent, KPS, informed the panel that it had withdrawn its Motion to Dismiss dated December 1, 2003.

A hearing was conducted on August 30-31, 2004, in Denver, Colorado on the matters of Muth's Cross Claims and KPS' Counterclaims. On or about August 27, 2004, Muth filed for Chapter 13 Bankruptcy. As a result, KPS' Counterclaim was stayed.

At the hearings on August 30-31, 2004, both parties made substantive motions. Muth renewed his oral Demand to Produce Documents and Motion for a Continuance. KPS submitted a written Motion in Limine, a written Response to the Motion for a Continuance, a written response to the demand for the further production of documents and an oral Motion to Dismiss. The panel deliberated on each of the Motions and made the following rulings: Muth's Demand to Produce Attorney-Client Privileged documents was denied, Muth's Motion for a Continuance was denied, KPS' Motion in Limine was granted and KPS' Motion to Dismiss was deferred.

Subsequently, there was another oral Motion for Continuance by Muth based upon his filing of Chapter 13 Bankruptcy and a renewed oral Motion to Dismiss by KPS. The parties were invited to brief the panel on the merits of proceeding with the hearing on Muth's claims. A letter from the Bankruptcy Trustee, a brief from KPS and an explanation of the brief by a Holme, Roberts and Owen bankruptcy attorney, Elizabeth Flaagan, were offered for the panel's review. After deliberation, the panel concluded there was no basis in law to prevent the panel from continuing the hearing on Muth's claims and denied Muth's Motion for a Continuance.

The panel then requested Muth provide his opening statement and/or his sworn testimony. The panel also made a determination not to allow Muth to offer any evidence that had not been produced to KPS. Muth orally requested additional time to provide his opening statement and/or his sworn testimony and KPS objected to any additional time requested by Muth. The Panel offered a brief continuance if Muth would confirm for the record that an opening statement/testimony would be made after the brief continuance, but Muth refused. After which, KPS renewed its oral Motion to Dismiss with Prejudice.

The panel confirmed that Muth did not intend to proceed with the presentation of his case. The Panel granted KPS' Motion to Dismiss Muth's claims with Prejudice and the hearing was terminated.

On or about September 21, 2004, the Bankruptcy Court modified the automatic stay, permitting KPS to prosecute its claims against Muth in this arbitration, while reserving its authority to allow for collection of any judgment.

KPS continued to pursue its claims against Muth at the April 26-28, May 23, June 6-7 and 14, 2005, hearings, during which time KPS offered the testimony of Kurt Kitson, Brad Buchanan, Dr. John Sherman, Paul Lundy, Cynthia King, Ken Cook and Kent Lund. Approximately 72 documents were accepted into evidence from KPS.

Muth denied the allegations made by KPS and asserted various defenses. Although a Motion was made by KPS to deny Muth from presenting evidence, after further discussion with the Panel, and in recess, KPS withdrew its Motion and allowed Muth the opportunity to present relevant evidence.

Muth offered his own testimony and that of Tom Birge, Esq. Dan Murphy, Mark Appleton, Esq. and J.D. Mayotte. Approximately 63 documents were accepted into evidence from Muth.

The Panel favored a liberal standard of admissibility in oral testimony and evidence.

At the June 14, 2005, hearing, KPS submitted a Trial Brief and Request for Specific Findings of Fact at the Hearing. Muth was afforded the opportunity to respond and did so on or about July 5, 2005.

At the conclusion of the hearing, KPS and Muth affirmed that they had been afforded a full and fair hearing.

After presentation of evidence, the panel made the following finding of fact:

- (Constructive Fraud) - Steven E. Muth's conduct resulted in actions that were contrary to KPS' best interests and such acts harmed KPS. Steven E. Muth employed deceptive practices, violated confidence and caused injury. There was insufficient evidence for the panel to make a finding of fraud. Furthermore, based upon the evidence and testimony, the panel concluded Steven E. Muth did not act alone or independently. Given the evidence and testimony, the panel could not ascribe specific damages caused solely by Steven E. Muth as his relationship with KPS, its employees and other non-employees was inextricably tied.

The parties have agreed that the Award in this matter may be executed in counterpart copies or that a handwritten, signed Award may be entered. In either case, the parties have agreed to receive conformed copies of the award while the originals remain on file with NASD Dispute Resolution ("NASD").

AWARD

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

1. Steven E. Muth's Cross-Claim, having been dismissed with prejudice at the August 31, 2004 in-person hearing, is denied in its entirety;
2. Steven E. Muth, is liable for and shall pay to Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc., the sum of One Million Eight Hundred Thousand Dollars and No Cents (\$1,800,000.00) in compensatory damages;
3. To the extent not specifically awarded or otherwise provided for above, all other claims and requests for relief by any party hereto, are denied with prejudice; and
4. Other than the Forum Fees noted below, the parties shall each bear all other costs and expenses incurred by them in connection with this proceeding, including but not limited to attorneys' fees.

FEES

Pursuant to the Code, the following fees are assessed:

Filing Fees

NASD Dispute Resolution will retain or collect the non-refundable filing fee for each claim:

Initial claim filing fee	= \$ 300
Cross claim filing fee	= \$ 600
Counterclaim filing fee	= \$ 5,000

Member Fees

Member fees are assessed to each member firm that is a party in these proceedings or to the member firm that employed the associated person at the time of the events giving rise to the dispute. In this matter, the member firm is Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc.

Member surcharge	= \$ 1,700
Pre-hearing process fee	= \$ 750
Hearing process fee	= \$ 5,500

Adjournment Fees

Adjournments granted during these proceedings:

June 16-20, 2003 - Adjournment requested by Respondent Steven E. Muth.
(Fee Assessed by the Panel) = \$ 1,200

Administrative Costs

Administrative costs are expenses incurred due to a request by a party for special services beyond the normal administrative services. These include, but not limited to, additional copies of arbitrator awards, copies of audio transcripts, retrieval of documents from archives, interpreters, and security.

Photocopying Fees (Steven E. Muth) = \$ 125
Archive Retrieval Fees (Steven E. Muth) = \$ 175

Forum Fees and Assessments

The Arbitration Panel assesses 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:

Five (5) Pre-hearing sessions with the Chairperson x \$ 450 = \$ 2,250

Pre-hearing conferences:	03/10/2004	1 session
	03/16/2004	1 session
	04/19/2004	1 session
	06/28/2004	1 session
	06/03/2005	1 session

Five (5) Pre-hearing sessions with Panel x \$ 1,200 = \$ 6,000

Pre-hearing conferences:	12/01/2003	1 session
	01/26/2004	1 session
	02/09/2004	1 session
	05/03/2004	1 session
	05/27/2004	1 session

Nineteen (19) Hearing sessions with Panel x \$ 1,200 = \$ 22,800

Hearing Dates: 08/30/2004 2 sessions

08/31/2004	2 sessions
04/26/2004	3 sessions
04/27/2005	2 sessions
04/28/2005	2 sessions
05/23/2005	2 sessions
06/03/2005	2 sessions
06/06/2005	2 sessions
06/07/2005	2 sessions
06/14/2005	2 sessions

Total Forum Fees	= \$ 31,050
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The Arbitration Panel has assessed \$ 22,125 of the forum fees to Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc.

The Arbitration Panel has assessed \$ 8,925 of the forum fees to Steven E. Muth.

FEE SUMMARY

Claimants, John L. Sherman and Jean A. Sherman, are jointly and severally liable for:

<u>Initial Filing Fee</u>	= \$ 300
Total Fees	= \$ 300
<u>Less payments</u>	= \$ 1,425
Balance Refunded By NASD Dispute Resolution	= \$ 1,125

Respondent, Kirkpatrick, Pettis, Smith, Polian, Inc., n/k/a KFS BD, Inc., is liable for:

<u>Counterclaim Filing Fee</u>	= \$ 5,000
Member Fees	= \$ 7,950
<u>Forum Fees</u>	= \$ 22,125
Total Fees	= \$ 35,075
<u>Less payments</u>	= \$ 7,950
Balance Due NASD Dispute Resolution	= \$ 27,125

Respondent, Steven E. Muth, is liable for:

Cross Claim Filing Fee	= \$ 600
<u>Forum Fees</u>	= \$ 8,925
Costs (Archives Retrieval)	= \$ 300
<u>Adjournment Fee</u>	= \$ 1,200
Total Fees	= \$ 11,025

<u>Less payments</u>	= \$ 175
Balance Due NASD Dispute Resolution	= \$ 10,850

All balances are payable to NASD Dispute Resolution and are due upon receipt pursuant to Rule 10330(g) of the Code of Arbitration

ARBITRATION PANEL

Mary C. Davis - Public Arbitrator, Presiding Chair
Gilbert L. McSwain, Esq. - Public Arbitrator
Gerald W. Wischmeyer, Esq. - Non-Public Arbitrator

Concurring Arbitrators:

Mary C. Davis
Public Arbitrator, Presiding Chair

Signature Date

Gilbert L. McSwain, Esq.
Public Arbitrator

Signature Date

Gerald W. Wischmeyer, Esq.
Non-Public Arbitrator

Signature Date

8/25/05
Date of Service (NASD use only)

Less payments	= \$ 175
Balance Due NASD Dispute Resolution	= \$ 10,850

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Public Arbitrator

8/25/05
Signature Date

Gerald W. Wischmeyer, Esq.
Non-Public Arbitrator

Signature Date

3/25/05
Date of Service (NASD use only)

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<u>Less payments</u>	= \$ 175
Balance Due NASD Dispute Resolution	= \$ 10,850

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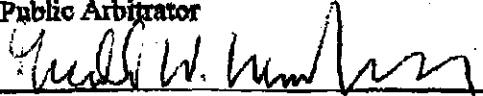
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Public Arbitrator, Presiding Chair

Signature Date

Gilbert L. McSwain, Esq.
Public Arbitrator

Signature Date



Gerald W. Wischmeyer, Esq.
Non-Public Arbitrator

8-25-05

Signature Date

8/25/05

Date of Service (NASD use only)