

**AWARD**  
**NASD Dispute Resolution**

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In the Matter of the Arbitration Between

Claimants

Randall P. Herman and Sharron FitzGerald

v.

03-01523

Minneapolis, Minnesota

Respondents

Paul Kuehn and Bill Kuehn

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Nature of Dispute: Customers v. Associated Persons

**REPRESENTATION OF PARTIES**

Randall P. Herman and Sharron FitzGerald ("Claimants") were represented by Thomas E. Jamison, Esq., of Fruth, Jamison & Elsass, P.A., Minneapolis, Minnesota.

Paul Kuehn ("Paul Kuehn") and Bill Kuehn ("Bill Kuehn"), hereinafter referred to as ("Respondents"), were represented by Geoffrey P. Jarpe, Esq., of Maslon Edelman Borman & Brand, Minneapolis, Minnesota.

**CASE INFORMATION**

The Statement of Claim was filed on or about February 28, 2003. Submission Agreements of Claimants were signed on or about February 27, 2003.

A Joint Statement of Answer was filed by Respondents Paul Kuehn and Bill Kuehn on or about August 28, 2003. Submission Agreement of Respondent Paul Kuehn was signed on or about April 14, 2004. Submission Agreement of Respondent Bill Kuehn was signed on or about April 14, 2004.

Respondents filed a Motion to Dismiss on or about April 30, 2003. Claimants filed a Response in Opposition to Respondents' Motion to Dismiss on or about May 15, 2003. Respondents filed a Memorandum in Support of the Motion to Dismiss on or about September 24, 2003.

**CASE SUMMARY**

Claimants asserted causes of action including the following: violation of Minn. Stat. § 80A.01, and negligence. The causes of action related to the allegation that Respondents induced Claimants to invest \$500,000 in a Secured Demand Note ("SDN") and assured them that regardless of the value of the assets in the SDN account, only the face amount of the SDN was at risk if MJK Clearing, Inc. became insolvent. Claimants asserted that the Securities Investor Protection Corporation ("S.I.P.C.")

took control of MJK Clearing on or about September 25, 2001 after MJK Clearing, Inc. revealed that it had a net capital shortfall in excess of \$50,000,000 and soon thereafter, S.I.P.C. seized Claimants' SDN account causing a loss of \$3,526,926.

Respondents denied the allegations set forth in the Statement of Claim and asserted defenses including the following: Respondents committed no misrepresentation or omission of any past or present material fact that could have been conceivably known that caused any loss or damage alleged by Claimants; Claimants voluntarily and knowingly assumed the risks of which they now complain, and as such are barred in whole or in part by the doctrines of contributory or comparative fault; Claimants have been paid more than \$1.5 million by the SIPC trustee on this loan transaction, and will likely receive further payments from the MJK Clearing Estate; Claimants cannot establish a sufficient causal relationship between any alleged responsibility of Respondents in these circumstances; and Respondents stated that there was no "sale or purchase of any security" within the meaning of Minn. Stat. §80A.01 in the loan and pledge transaction involved here, and thus Minn. Stat. § 80A.01 and 80A.23 are inapplicable.

#### **RELIEF REQUESTED**

Claimants requested an award in the amount of \$3,526,926 in compensatory damages. In addition, Claimants requested attorney's fees, interest, costs and any other relief that the Panel deemed just and equitable.

Respondents requested that the claims asserted against them be denied in their entirety and that they be awarded their costs and attorneys' fees.

#### **OTHER ISSUES CONSIDERED & DECIDED**

On or about August 22, 2003 the Panel ordered that the Parties provide briefs on the issue of whether the Statement of Claim is barred by the *res judicata* doctrine of merger and bar by reason of the final judgment in *John Hanson, Randall P. Herman, Sharron FitzGerald, et al v. Dane Johnson Paul Kuehn, Bill Kuehn, et al.* Claimants filed a Memorandum of Law on *res judicata* on or about October 3, 2003. Respondents filed a reply Memorandum in further support of their Motion to Dismiss *res judicata* on or about October 7, 2004.

On or about February 12, 2004, the Panel denied Respondents' Motion to Dismiss.

The Panel has made the following findings:

1. In March 2000, Claimants and Miller, Johnson & Kuehn, Inc. (MJK) entered into the following: (a) a Subscription Agreement and Letter of Investment Intent and (b) a Secured Demand Note Collateral Agreement.

2. Pursuant to the agreements described in paragraph #1 above, in March 2000, Claimants executed a Secured Demand Note for \$500,000 to MJK and a Subordinated Loan Agreement Lender's Attestation and deposited securities then worth \$991,250 as collateral for the SDN into a new non-discretionary Secured Demand Note account with MJK. (Hereafter "the SDN transaction"). Thereafter, MJK provided regular account statements for the SDN account to Claimants.
3. The SDN transaction and its documentation were in compliance with the SEC's regulations regarding SDNs (17 CFR § 240.15c3-1d Satisfactory Subordination Agreements (Appendix D)).
4. Pursuant to said regulations, the SDN transaction documents were submitted to the NASD for review and approval, and in March 2000 the NASD approved same.
5. At the opening of the SDN account, there was excess collateral of \$193,875. This was calculated as the value of the collateral (\$991,250) less the face value of the SDN (\$500,000) and less a "haircut" amount (\$297,375).
6. After March 2000, the market value of the securities that were deposited in the SDN account increased, thus resulting in an increasing amount of excess collateral.
7. On or about December 2000, as a result of a corporate reorganization, the SDN account was transferred to a new, related entity, Miller Johnson Steichen Kinnard (MJSK). MJK changed its name to MJK Clearing, Inc., whose activities were then limited to clearing securities trades. Thereafter until September 2001, MJSK provided regular account statements for the SDN account to Claimants.
8. In September 2001, the U.S. Bankruptcy Court for the District of Minnesota issued an order finding that the MJK customers were in need of the protection of the Securities Investors Protection Act and appointed a trustee for the liquidation of MJK.
9. In November 2001, the MJK trustee issued a notice to Claimants and other SDN lenders that any claim by them for return of excess collateral would be subordinate to claims of customers and unsecured general creditors. Under the circumstances, Claimants were thereby put at risk of losing the entire value of their excess collateral, then nearly \$2 million.
10. Thereafter, negotiations ensued between the trustee and the SDN lenders, including Claimants. This resulted in a settlement whereby the lenders would receive 50% of their excess collateral plus a right to obtain additional monies if substantial recoveries were made on behalf of the Trustee against third parties and if creditors with superior rights were paid. Pursuant to that settlement, in April 2003, Claimants received from the MJK

Trustee \$316,525 in cash plus 13,508 of the shares that had been deposited in the SDN account while the Trustee retained the other 21,942 shares. Although there was no precise evidence as to the value of the shares at this time, it appears as if the 13,508 shares that were returned to Claimants under the settlement were worth at least \$450,000. Thus, under the settlement, Respondents received at least \$780,000.

11. Before the SDN transaction, Claimants were customers of MJK and Respondents, where they had non-discretionary accounts.
12. Before the SDN transaction, each of the Respondents orally told Claimants that all that was at risk of loss in the SDN was the face amount of \$500,000 and that any pledged collateral whose value exceeded that amount (excess collateral) was not at risk of loss.
13. Respondents relied upon these oral representations in deciding to enter into the SDN transaction in March 2000, and in deciding thereafter not to remove any excess collateral from the SDN account.
14. Said oral representations were false when made.
15. Said oral representations were not made with any intent to deceive by Respondents.
16. Said oral representations were not made with any recklessness by Respondents.
17. Said oral representations were not made with any negligence by Respondents. Respondent Paul Kuehn had obtained a 03/03/1994 memorandum from MJK's chief financial officer describing the SDNs that were used by that firm and stating (erroneously) that the "investor's liability is limited to the face amount of the SDN," and Respondents' oral representations were consistent with that language. Moreover, there was no express statement or warning in the SEC's regulations regarding SDNs (17 CFR § 240.15c3-1d Satisfactory Subordination Agreements (Appendix D)) that any excess collateral for SDNs was at risk of loss, and the same was true with respect to the transaction documents in this case that were in compliance with that regulation. Finally, there were no articles in the financial press on the issue of whether or not any excess collateral for a SDN was at risk of loss, according to the testimony of Claimants' expert witness. In short, Respondents exercised the degree of care and skill usually exercised by members of the broker profession under similar circumstances in determining the terms of the SDNs and in telling Claimants about the SDNs. In March 2000, and thereafter, Respondents did not know, and in the exercise of reasonable care could not have known, of the existence of facts by reason of which their liability is alleged to exist, *i.e.*, that the excess collateral for SDNs was at risk of loss in an insolvency of MJK.

Based upon these findings, the panel concludes the following:

1. Count Two of the Statement of Claim asserts that Respondents were negligent in making their oral representations regarding the SDN in question and in managing Respondents' SDN account. However, as already noted, Respondents were not negligent in making those representations. In addition, since the SDN account was a non-discretionary account, Respondents and their employer (originally MJK and later MJSK) did not have a duty to manage the account other than to provide regular account statements for the SDN account to Claimants, and MJK (and later MJSK) did just that. Therefore, Respondents were not negligent in managing that account, and Count Two fails for lack of proof.
2. Count One of the Statement of Claim asserts a claim under the Minnesota Securities Act, and the Joint Statement of Answer asserts that there was "no misrepresentation or omission of any past or present fact that could have been conceivably known that caused any loss or damage."
3. The Minnesota Securities Act provides, in part, that it is unlawful "for any person in connection with the offer, sale or purchase of any security, directly or indirectly . . . to make any untrue statement of a material fact or to omit to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Minn. Stat. § 80A.01 (b).
4. The Minnesota Securities Act also provides that:

"Any person who violates section 80A.01 in connection with the purchase or sale of any security shall be liable to any person damaged thereby who sold such security to that person or to whom that person sold such security." (Minn. Stat. § 80A.23, subd. 2.)
5. The Minnesota Securities Act also provides that:

"Every person who directly or indirectly controls a person liable under subdivision 1 or 2 [of section 80A.23], every partner, principal executive officer or director of such person, every person occupying a similar status or performing a similar function, every employee of such person who materially aids in the act or transaction constituting the violation, and every broker-dealer or agent who materially aids in the act or transaction constituting the violation, are also liable jointly and severally with and to the same extent as such person. There is contribution as in cases of contract among the several persons so liable." (Minn. Stat. § 80A.23, subd. 3.)

6. The Minnesota Securities Act also provides that:

“No person shall be liable under subdivisions 1 to 3 [of section 80A.23] who shall sustain the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of facts by reason of which the liability is alleged to exist.” (Minn. Stat. § 80A.23, subd. 4.)

7. These provisions of the Minnesota Securities Act have been interpreted by the Minnesota courts to not require intent to deceive or recklessness, but instead to require at least a showing of negligence by the defendants. (*Siler v. Principal Fin. Sec., Inc.*, 2000 WL 1809048, at 4 (Minn. Ct. App. 2000); *Sprangers v. Interactive Technologies, Inc.*, 394 N.W.2d 498, 503 (Minn. Ct. App.), *review denied* (Minn. Sup. Ct. 1986); cf. *MERF v. Allison-Williams*, 519 N.W.2d 176, 181 (Minn. Sup. Ct. 1994)(dictum).)
8. MJK, in connection with the offer, sale or purchase of a security (the SDN) did make untrue statements of a material fact or omitted to state material facts necessary in order to make the statements that were made, in the light of the circumstances, were not misleading and thereby violated Minn. Stat. § 80A.01(b).
9. Claimants relied upon the above representations in deciding to enter into the SDN transaction.
10. Prior to and during March 2000, Respondent Paul Kuehn was a principal executive officer of MJK. In addition, at that time, Respondents were employees of MJK and brokers who materially aided the SDN transaction.
11. Thus, the prima facie requirements for Respondents' liability under the Minnesota Securities Act were established.
12. However, as previously noted, Respondents did not act with an intent to deceive or with recklessness. Nor, as also noted, did they act with negligence. Therefore, Respondents' affirmative defense under Minn. Stat. § 80A.23, subd. 4 has been proven. As a result, Count One fails.
13. As already noted, the panel finds that the SEC's regulations regarding SDNs (17 CFR § 240.15c3-1d Satisfactory Subordination Agreements (Appendix D)) do not provide any express warning or disclosure that any excess collateral is at risk of loss in the insolvency of a broker-dealer and that the transaction documents that are in compliance with that regulation and that were approved by the NASD also do not contain any such express warning or disclosure. Thus, in this case, both Claimants and Respondents were not apprised of this risk. If it is the intent of the SEC that such excess collateral be at risk of

loss in an insolvency, then this panel STRONGLY RECOMMENDS THAT THE SEC AMEND THE REGULATION TO SO STATE AND THAT THE SEC AND/OR THE NASD AMEND THE STANDARD FORMS FOR SDNs TO SO STATE.

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. Claimants' claims, each and all, are hereby denied and dismissed with prejudice in their entirety;
2. 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
3. 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 the non-refundable filing fee for each claim:

Initial claim filing fee = \$ 600

#### **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 arbitrator(s), including a pre-hearing conference with the arbitrator(s), that lasts four (4) hours or less. Fees associated with these proceedings are:

One (1) Pre-hearing session with Panel x \$ 1,200 = \$ 1,200

Pre-hearing conference: 08/22/2003 1 session

Four (4) Hearing sessions with Panel x \$ 1,200 = \$ 4,800

Hearing Dates: 04/14/2004 2 sessions  
04/15/2004 2 sessions

Total Forum Fees = \$ 6,000

The Arbitration Panel has assessed \$ 3,000 of the forum fees jointly and severally to Randall P. Herman and Sharron FitzGerald.

The Arbitration Panel has assessed \$ 3,000 of the forum fees jointly and severally to Paul Kuehn and Bill Kuehn.

**Fee Summary**

Claimants, Randall P. Herman and Sharron FitzGerald are jointly and severally liable for:

Initial Filing Fee	= \$ 600
<u>Forum Fees</u>	<u>= \$ 3,000</u>
Total Fees	= \$ 3,600
<u>Less payments</u>	<u>= \$ 1,800</u>
Balance Due NASD Dispute Resolution	= \$ 1,800

Respondents, Paul Kuehn and Bill Kuehn are jointly and severally liable for:

<u>Forum Fees</u>	<u>= \$ 3,000</u>
Total Fees	= \$ 3,000
<u>Less payments</u>	<u>= \$ 0</u>
Balance Due NASD Dispute Resolution	= \$ 3,000

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**

Duane W. Krohnke, Esq. - Public Arbitrator, Presiding Chair  
Mark S. Gleason, Esq. - Public Arbitrator  
Emily B. Boote- Non-Public Arbitrator

**Concurring Arbitrators:**

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Duane W. Krohnke, Esq.  
Public Arbitrator, Presiding Chair

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Signature Date

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Mark S. Gleason, Esq.  
Public Arbitrator

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Signature Date

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Emily B. Boote  
Non-Public Arbitrator

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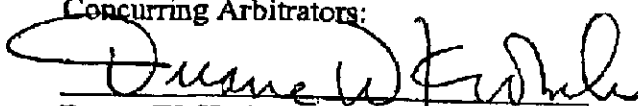
Signature Date

5/5/04  
Date of Service (NASD use only)

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Public Arbitrator, Presiding Chair

*Mark S. Gleason*

Mark S. Gleason, Esq.  
Public Arbitrator

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Signature Date

*4/30/04*

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Signature Date

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Emily B. Boote  
Non-Public Arbitrator

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Signature Date

*5/5/04*

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Date of Service (NASD use only)

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Mark S. Gleason, Esq.  
Public Arbitrator

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Signature Date

Emily B. Boote  
Emily B. Boote  
Non-Public Arbitrator

May 3, 2004  
Signature Date

5/5/04  
Date of Service (NASD use only)