

N.A.S.D. AWARD

NATIONAL ASSOCIATION OF SECURITIES DEALERS

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In the Matter of the Arbitration Between

Name of Claimant/Counter-Respondent

Control Specialties Inc.

92-02210

Name of Respondents/Counter- and  
Third-Party Claimants

First City Brokerage Company;  
First City, Texas-Houston N.A.

Third-Party Respondent

R. R. Pennington, Jr.

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**REPRESENTATION**

For Claimant/Counter-Respondent: Control Specialties Inc. was represented by Brent Spivey, Esq. of Norton & Blair, located in Houston, Texas.

For Respondents/Counter- and Third-Party Claimants: First City Brokerage Company and First City, Texas-Houston N.A. were represented by Darryl W. Malone, Esq. of Gilpin, Paxson & Bersch, located in Houston, Texas. Respondent First City, Texas-Houston N.A. was also represented by Mary E. Baker, Esq. of the Federal Deposit Insurance Corporation, as Receiver of the First City, Texas-Houston N.A., located in Houston, Texas.

For Third-Party Respondent: R.R. Pennington, Jr. was represented by Brent Spivey, Esq. of Norton & Blair, located in Houston, Texas.

**CASE INFORMATION**

Statement of Claim filed: July 6, 1992.

Claimant/Counter-Respondent's Submission Agreement signed on: June 27, 1992 by R.R. Pennington, Jr., President of Control Specialties Inc.

Statement of Answer, Counterclaim and/or Third-Party Claim filed by Respondents/Counter- and Third-Party Claimants First City Brokerage Company and First City, Texas-Houston, N.A. filed: August 25, 1992.

Respondent First City Brokerage Company's Submission Agreement signed on: August 19, 1992 by Mary Ricketts, President, First City Brokerage Company.

Respondent First City Texas-Houston NA signed on: August 25, 1992 by Scott M. Goode, Vice President, First City, Texas-Houston, N.A.

Claimant/Counter-Respondent Control Specialties, Inc.'s Reply to Counterclaim filed: September 29, 1992.

Third-Party Respondent R.R. Pennington, Jr.'s Answer to Third Party Claim filed: September 29, 1992.

Respondents' Motion for Default or, alternatively, to Bar Filing of Answer by Counter-Respondent filed: September 18, 1992.

Response to Motion for Default, or alternatively, to Bar Filing of Answer by Counter-Respondent and Request for Extension of Time to File Responsive Pleading filed: September 18, 1992.

Plea for Intervention filed by the Federal Deposit Insurance Corporation, Receiver of First City, Texas-Houston, N.A. on: December 14, 1992.

Motion to Dismiss Without Prejudice filed by Claimant/Counter-Respondent Control Specialties, Inc. on: March 8, 1993.

Amended Statement of Answer, Counter-Claim and/or Third-Party Claim filed by Respondent/Counter-Claimant and Third-Party Claimant First City Brokerage Company on: January 21, 1993.

### **HEARING INFORMATION**

Pre-Hearing Conference: None Held.  
Hearing Date/Sessions: March 18, 1993 for Three (3) sessions.  
Hearing Location: Houston, Texas.

### **CASE SUMMARY**

Claimant/Counter-Respondent Control Specialties, Inc. ("CSI") alleged that Respondent/Counter- and Third-Party Claimant First City Brokerage Company ("FCBC") and First City Texas-Houston N.A. ("First City") failed to properly execute the sale and subsequent buy-in of stock

in Keystone International, Inc. stock ("Keystone Stock") to the detriment of CSI and Third-Party Respondent R.R. Pennington, Jr. ("Pennington"). CSI specifically alleged that:

1. On February 6, 1992, CSI contacted a broker at FCBC for the purpose of selling 28,048 shares of Keystone Stock at the best price near \$29 a share. The shares were sold at a price of 29.7544, with CSI informed FCBC that its bank would deliver the stock and that FCBC was to make arrangements with the bank regarding execution of the orders;
2. The sales were halted when FCBC's broker was told that the stock was restricted. Pennington advised the broker to keep selling and not worry about the restriction because it did not apply. The broker agreed and Pennington and CSI were led to believe that the sale was accomplished;
3. On February 7, 1992, the account papers were forwarded to Pennington's office for signature. Pennington again reassured FCBC's broker that there was no problem with the restriction and that he would get together with him to exchange the necessary paperwork;
4. On February 12, 1992, the restriction on the shares was removed and they were available for immediate sale. However, CSI recognized that the stock which was sold, obtained a much higher price than the current market price. Realizing this, Pennington talked to representatives of FCBC, and with their assurances and recommendations, CSI requested FCBC to buy-in 28,050 shares for its account, with the express understanding that these shares would be available on February 13, 1992, for settlement of the February 6, 1992 sale. In addition, on February 12, 1992, additional confirmation of the transferability of the shares was provided to FCBC, including a memorandum setting forth the method of sale and the steps to take to obtain stock certificates without the legend, as well as a Prospectus settlement;
5. Contrary to its express written and oral commitments, FCBC decided that the transactions in question involved a short sale and that any proceeds realized would not be remitted to CSI or Pennington because of unspecified procedural problems. The characterization of the transaction as a short sale is immaterial because there was no contravention of any rule promulgated by the SEC and no infringement of any public interest would have occurred if the transaction was completed as expected;
6. FCBC failed to properly execute the sale and subsequent buy-in of the Keystone stock and the administrative impediments now identified by FCBC could have been easily allayed. At a minimum, FCBC failed to advise CSI of their

inability to complete the transaction as structured and denied CSI the opportunity to pursue alternative methods to accomplish the desired result.

Based upon the above allegations, CSI asserted violations of the anti-fraud provisions of the securities statutes; breach of contract; common law fraud and misrepresentation; negligence and gross negligence; and breach of fiduciary obligation.

Respondents FCBC and First City denied the material allegations of the Statement of Claim, alleging that:

1. First City is a separate entity from FCBC. had no involvement in the sales and purchases complained of, and no complaint is raised against it in the Statement of Claim;
2. On February 6, 1992, Pennington, in response to clear, direct questioning, told FCBC's broker that the stock was pledged, but was unrestricted and capable of being transferred. Based upon Pennington's representations, firm instructions and easily verifiable references, the broker began the process of selling the stock;
3. When the broker contacted the bank that was holding the stock as collateral to learn the requirements for releasing the stock for transfer, he was told that the stock certificate bore a legend that created a cloud regarding the transferability of the stock. In order to make delivery of the stock, CSI had to either cause the legend to be removed or satisfactorily establish that the stock was transferrable notwithstanding the language of the legend. The broker immediately and properly notified the trader to stop selling the stock;
4. When confronted about the legend, Pennington responded that the legends did not represent a problem, claiming that the restrictions had nothing to do with the stock, but related to some agreement CSI had with other shareholders and only applied to the shares of the stock CSI was not trying to sell. Pennington stated that the matter would be cleared up and the stock deliverable by settlement day. Based upon the assurances, the sale was completed with February 13, 1992 being the settlement day in accordance with industry custom and the rules of the exchange;
5. Pursuant to the Customer Agreement, CSI was required to deliver the shares to FCBC on February 12, 1992. However, Pennington contacted FCBC on that date and represented that while CSI was able to sell the stock, doing so would violate a contract CSI had with third parties, the shares would not be delivered and that FCBC should buy 28,050 shares of Keystone. The broker told Pennington that the stock could be bought, but that CSI might not be entitled to

any profit because CSI would not deliver the stock it had committed to sell. Pennington asked that the February 6 sale be treated as a short sale and was told that it had not been entered as a short sale:

6. On February 13, the President of FCBC told Pennington that if CSI could deliver its stock in accordance with its obligations, it would receive the proceeds from the February 6 sale. Pennington replied that CSI would not be making delivery of the stock, but that CSI would satisfy its obligations by delivering a cashier's check in order to purchase securities that CSI could then deliver. Pennington was told that this was improper because he was suggesting that CSI be permitted to sell stock that it did not own, that this course of action would violate SEC regulations regarding short sales and that one is required to deliver fully paid for transferrable stock. CSI did not make delivery of any stock:

7. It would be illegal to treat the transaction as a short sale because it had not been treated as a short sale, borrowing arrangements must be made with the clearing broker, and short sales must be effected in compliance with Regulation T, 12 C.F.R. Part 220. In addition, by failing to tender any securities for delivery and by never making payment of any securities CSI claims to have agreed to purchase, CSI has waived any right to complain about the purchase.

In addition, FCBC asserted a Counterclaim and Third-Party Claim against CSI and Pennington, alleging that they induced FCBC to enter into a contract in a stock transaction by means of false representations in violation of the Tex. Bus. & Comm. Code Par. 27.01(a)(1) and (2), common law fraud and breach of contract.

In its Amended Statement of Answer, Counterclaim and/or Third-Party Claim, FCBC asserted additional "superdefenses" based upon the failure of First City, Texas-Houston, N.A., of which FCBC was a wholly-owned subsidiary. Therefore, FCBC raised the defenses afforded by 12 U.S.C. Sec. 1823(e); D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 62 S. Ct. 676, 86 L.Ed. 956 (1942) and its progeny; Gunter v. Hutcheson, 674 F.2d 862 (11th Cir. 1982); and any other applicable statutes or common law.

CSI denied the material allegations of the Counterclaim, alleging that the shares of Keystone stock sold through FCBC were not subject to the restriction and were fully transferable according to the terms and conditions of the Shareholders' Agreement; FCBC was given all necessary information of the status of Keystone stock at all material times, then effected the sale, repurchased shares on the open market and allocated the profit for its own account; and CSI provided FCBC with all information necessary to the effect the sale consistent with all regulatory rules. In addition, CSI asserted as affirmative defenses the doctrine of equitable estoppel or the doctrine of unclean hands; waiver of the conduct complained of because of FCBC's own actions; and FCBC has not been damaged, but instead has received an economic benefit.

Pennington denied the allegations of the Third-Party Claim, making the same allegations and affirmative defenses made by CSI in defense of the Counterclaim.

### **RELIEF REQUESTED**

Claimant/Counter-Respondent Control Specialties Inc. requested entry of an award against Respondents in the amount of \$79,380.03 for actual damages; full reimbursement for costs of arbitration and attorneys' fees; and for other relief at law or in equity that would be appropriate, including the assessment of exemplary damages. In addition, CSI requested that all relief requested by FCBC be denied and that nothing be awarded to FCBC.

Respondent/Counter-Claimant/Third-Party Claimant First City Brokerage Company requested that all relief requested by CSI be denied; that FCBC be granted an award permitting it to retain its profits in the above transactions, and for reasonable attorneys' fees, expert witness fees costs of copies of depositions, if any, and costs of arbitration, and any court costs incurred in confirming the award.

Third-Party Respondent Pennington requested that all relief requested by FCBC be denied and that nothing be awarded to FCBC, and that the relief filed by Pennington in the Statement of Claim, together with reasonable and necessary attorneys' fees and other costs be awarded.

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

On December 14, 1992, the Federal Deposit Insurance Corporation ("FDIC"), Receiver of First City, Texas-Houston, N.A. filed a Plea in Intervention, acknowledging that the bank had been declared insolvent and was the only entity through which the bank could be sued. Therefore, the FDIC was the proper party to defend the Claim against the bank.

On March 8, 1993, Claimant/Counter-Respondent CSI filed a Motion to Dismiss without Prejudice Respondent FDIC as Receiver for First City, Texas-Houston, N.A. There was no objection to the Motion, and the panel determined that the Motion would be granted.

At hearing, FCBC withdrew its Motion to Bar the Filing of Answers and therefore, the Panel made no ruling on the matter.

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 original remain on file with the NASD.

### **AWARD**

After considering the pleading, 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. The Statement of Claim asserted by Claimant/Counter-Respondent Control Specialties, Inc. is hereby dismissed and denied in its entirety;
2. Claimant/Counter-Respondent Control Specialties Inc. and Third-Party Respondent R.R. Pennington, Jr. are jointly and severally liable for and shall pay to the Respondent/Counter-Claimant/Third-Party Claimant First City Brokerage Company the sum of \$3,500.00;
3. Respondent Federal Deposit Insurance Corporation ("FDIC"), as Receiver of First City, Houston, N.A., is hereby dismissed without prejudice pursuant to the Motion of Claimant/Counter-Respondent Control Specialties Inc. and the Order entered on March 18, 1993;
4. The parties shall bear their own costs of arbitration, including any attorneys' fees, except for those specifically enumerated herein.

### **FORUM FEES**

Pursuant to Section 43(c) of the Code of Arbitration Procedure, the following Forum Fee(s) are assessed: Three (3) hearing sessions x \$500.00 per hearing session = \$1,500.00.

The National Association of Securities Dealers, Inc. shall retain the claim filing fee of \$150.00 and the hearing session deposit of \$500.00 previously deposited by the Claimant/Counter-Respondent, Control Specialties Inc. In addition, the NASD shall retain the excess hearing session deposit of \$450.00 previously deposited by the Claimant/Counter-Respondent Control Specialties Inc. In addition, Claimant/Counter-Respondent Control Specialties Inc. and Third-Party Respondent R.R. Pennington, Jr. are jointly and severally liable for and shall pay to the NASD additional forum fees in the sum of \$550.00. The NASD shall retain the claim filing fee of \$250.00 and refund the hearing session deposit of 550.00 previously deposited by the

Respondent/Counter-Claimant/Third-Party Claimant First City Brokerage Company.

Fees are payable to the National Association of Securities Dealers, Inc.

Concurring Arbitrators' Signatures  
Name

Date

Franklin Anthony Arnold, Esq.  
Franklin Anthony Arnold, Esq.  
Public Arbitrator  
Chairperson

June 29, 1993

George A. Sellnau, Esq.  
George A. Sellnau, Esq.  
Public Arbitrator

June 22, 1993

Frederick W. McGinnis  
Frederick W. McGinnis  
Industry Arbitrator

June 30, 1993

Date of Service of Award: 6-30-93