

11/95

**NATIONAL ASSOCIATION OF SECURITIES DEALERS
AWARD**

In the Matter of the Arbitration Between

Mel F. Pervais,

Claimant.

v.

NASD No. 93-349

Kidder, Peabody & Co., Cruttenden & Co.,*
and Richard Adler,

Respondents.

Representation

For Claimants: Kyle Kennelly, Julian, California, Richard DeVita, Esq. of Hoboken, New Jersey
and Frederick Phillips, Esq. of Phillips, Haskett & Ingwerson, San Diego, California

For Respondents Cruttenden & Co and Richard Adler: John Loftus, Esq. and Janet
Simmons, Esq. of Keesal, Young & Logan, Long Beach, California

For Respondent Kidder, Peabody & Company: Jon Rewinski, Esq. of Kindel & Anderson,
Los Angeles, California

Case Information

Statement of Claim filed: January 18, 1993

Supplement and Amendment to Statement of Claim filed: April 13, 1994

Claimant's Submission Agreement signed: June 16, 1993

Statement of Answer filed on: September 21, 1993

Statement of Answer to Supplement and Amendment to Claim: April 24, 1994

Respondents' Submission Agreement signed on:

Richard Adler - September 28, 1993, Although duly served,
Kidder Peabody and Co. and Cruttenden & Co. did not file submission agreements but
are subject to National Association of Securities Dealers (NASD) jurisdiction in
accordance with NASD Code of Arbitration Procedure Section 12. Kidder Peabody & Co.
was dismissed prior to the hearing and Cruttenden & Co. submitted to jurisdiction at the

hearing.

Hearing Information

Prehearing Conference Date(s)/Sessions: June 28, 1995

Hearing Date/Sessions: August 14-18, 1995, October 9-13, 1995/two sessions each day

Hearing Location: San Diego, California

Case Summary

Claimant Mel F. Pervais (Pervais) alleged breaches of fiduciary duties, and failure to supervise, by Respondents in misusing their discretionary authority to purchase and sell stocks, options and bonds in Pervais' account contrary to a specific written plan (the Plan) developed by Adler and agreed upon by Pervais to govern Pervais' account. Pervais also alleged that the transactions and the securities involved were unsuitable in the light of Pervais' expressed investment needs and objectives. Pervais also alleged that Respondents utilized their discretionary authority to engage in grossly excessive trading in Pervais' account, which Respondents controlled, contrary to Pervais' best interests and solely to earn commissions. Pervais also alleged that Respondents made various misrepresentations to him from time to time in connection with the purchase and sale of securities in his account; among these misrepresentation were oral misrepresentations and written misrepresentations made in correspondence and in quarterly reports to the effect that the Plan was being properly adhered to in Pervais' best interest so as to "protect the principal at all costs".

Claimant also asserted that effective in January 1985 Pervais sold his ownership interest in Cataract , Inc. to the Cataract Employee Stock Ownership Plan Trust, or ESOP, for \$20 million, payable over five years. He further alleged that, absent special tax treatment, Pervais, who had a tax basis of \$35,000 in his Cataract stock, would have realized almost \$20 million of taxable capital gain from the sale, resulting in potential income tax liability of more than \$5 million; however, the tax law permits the "non-recognition" of such capital gain if the seller purchases and holds "qualifying securities" in accordance with IRS rules and regulations. Claimant alleged that the purchases must be made during a period commencing three months prior to the sale to the ESOP and ending 12 months after the sale to the ESOP, and recognition of gain is deferred only so long as the taxpayer continues to hold the qualifying securities (the gain may never have to be realized if taxpayer holds the qualifying securities until he dies).

Claimant also asserted that in meetings in December 1985 Pervais and Respondent Adler agreed on an investment plan (the "Plan") which Adler represented would permit Pervais' to acquire and hold qualifying securities, on a leveraged basis, with safety and at the same time "realize protection of capital and still provide the opportunity to earn adequate return." He maintained that the most essential feature of the Plan was Adler's assurances to Pervais that Adler could and would, by the use of options, protect (or "hedge") the portfolio against any significant losses in the event of a downturn in the market. Claimant argued that Adler represented to Pervais that the options strategy which would accomplish this result was

sophisticated and complicated but that Adler was expert in devising and implementing such an options strategy. Claimant further alleged that he believed Adler and relied on him. Claimant asserted that another material feature of the Plan was that income from the mix of bonds and dividend-paying securities would cover both the cost of the hedging operation and the margin interest.

Claimant also asserted that after the meetings in December 1985, and upon the advice of Adler, Pervais agreed to the Plan and opened several securities accounts with Adler at Kidder Peabody, including the margin account referred to by the parties as the ESOP account, which is the only account complained of in this arbitration. Pervais alleged that he deposited \$3.4 million into the ESOP account, and executed a power of attorney granting Adler discretionary authority to trade in the ESOP account, and that, in accordance with the Plan, Adler incurred margin debt of over \$5 million in the account and promptly purchased approximately \$8.6 million of blue chip securities, including stock, options and bonds; e.g., securities of IBM, AT&T, Westinghouse Electric, Advanced Micro Devices, General Electric, Wang Labs, Amoco, Phillips Petroleum, Mellon Bank, Baltimore Gas & Electric, Virginia Electric, Alabama Power, American Telephone and Hammond Mortgage. Pervais alleged that he maintained the ESOP account with Adler at Kidder Peabody for approximately six months, until June of 1986, and Pervais does not complain of transactions in the account during that period of time.

Claimant also asserted that in April 1986 Adler negotiated an arrangement whereby Adler would purchase a 33% ownership interest in Cruttenden for \$500,000, resign at Kidder Peabody and become a broker at Cruttenden. He alleged that on May 5, 1986 Adler flew to Florida for a meeting with Pervais to solicit Pervais to move his account to Cruttenden, and that Adler brought Cruttenden's new account forms with him, and, at Adler's request, Pervais signed such forms in blank, and Adler took them with him. He argued that those forms were later (after Pervais signed them) completed falsely to indicate, without Pervais' knowledge or consent, that Pervais desired to engage in a program of speculative high-risk short-term trading in options and stocks in the ESOP account. Pervais further argued that he did not intend by signing such forms to change his investment objectives or the investment Plan.

Claimant also asserted that in late June 1986 Adler moved to Cruttenden and transferred Pervais' ESOP account from Kidder to Cruttenden using the new account forms which Pervais had signed in blank for this purpose. He alleged that Adler immediately commenced active short-term trading in the ESOP account, and that during the entire sixteen months that Adler managed the ESOP account at Cruttenden before the crash on 'black Monday', October 19, 1987, Respondents engaged in the activities complained of, including numerous short-term trades in and out of various securities, both stocks and options. He maintained that during some or all of that period, Adler did not hedge the account against downside risk as he had promised and had been instructed and as the Plan provided, but instead, in fact sometimes sold puts so as to greatly increase the risk. He further argued that at the time of the crash there were puts outstanding in three securities which resulted in losses of approximately \$450,000. He maintained that Adler had total control over the trading in the ESOP account., that Pervais never ordered or recommended the purchase or sale of a single security in that account, that all transactions were initiated and consummated by Adler, that it was Adler's violation of Pervais'

trust, confidence and specific instructions in the Plan that led to the losses in the ESOP account, and that Adler acted with wilful and reckless disregard for Pervais' interests.

Claimant also asserted that Respondents' breach of their duties to hedge and protect the ESOP account against downside risk resulted in a margin call on black Monday and the forced liquidation of \$2.4 million of qualifying securities. He alleged that at that time Adler on his own initiative liquidated an additional \$1.5 million of qualifying securities to raise cash which Adler wanted available; and the result was that Pervais had to recognize in 1987 taxable capital gains of approximately \$3.9 million which he would not have recognized if Respondents had not violated their trust. Claimant alleged that the securities which Adler selected to be liquidated were bonds with the result that the ESOP account would no longer be self-sustaining. Claimant maintained that, after the crash, Adler continued to trade in the ESOP account until it was closed in August 1988, 22 months after it was opened; that during those 22 months, Adler and Cruttenden generated commissions of approximately \$450,000 from the Pervais ESOP account, representing approximately 25% of the total commission income of Cruttenden for that period; and that Pervais paid Cruttenden margin interest of approximately \$540,000 on the account. He alleged that total out of pocket losses in the ESOP account while at Cruttenden were approximately \$1,090,000.

Respondents Cruttenden & Co. and Adler denied any and all liability to Claimant and further denied that Claimant is entitled to any relief whatsoever. Respondents also asserted 17 affirmative defenses.

Respondents alleged that Pervais was referred to Adler by Richard M. Squar, (Squar) an acquaintance of Adler who was a prominent certified public accountant in the Newport Beach area. Respondents alleged that Adler met with Pervais twice for more than seven hours regarding Pervais' background and investment objectives. Respondents further alleged that Pervais was not, and did not portray himself as, an inexperienced investor but instead represented that he had 25 years experience investing in bonds and real estate, ten years experience investing in securities and one year of options and futures investing. Respondents asserted that after realizing \$20 million from the sale of his company, Pervais' objective was to invest in as many replacement securities as possible to maximize the amount of capital gains tax he could defer.

Respondents also alleged that Adler did not design the the tax deferral aspects of the Plan but that Pervais and a group of advisors, including several prominent lawyers and Pervais' accountant, Squar, set up the ESOP guidelines before Adler came on the scene. Respondents alleged that Pervais then approached Adler to select a portfolio of securities and that Squar was given the job of telling Adler whether or not a proposed security qualified as a replacement security; so that Squar thus approved and disapproved the purchase of securities which Adler selected for the portfolio and was involved in setting up the portfolio under the Plan. Respondents asserted that the tax law provides, with respect to the sale of a business to an ESOP, that, in order to achieve deferral of gain, the taxpayer must invest the money received in rollover securities within 12 months of the sale; but that since Pervais didn't get the full \$20

million in that 12 month period, he could invest only a portion of the sale proceeds in the rollover securities. Respondents further alleged that although Pervais received in excess of \$6 million that first year, he chose to invest only \$3.4 million with Kidder. Respondents alleged that Adler's main contribution to the design of the investment Plan was to suggest that Pervais could leverage the \$3.4 million so as to purchase securities up to \$8.6 million and have a tax deferral on \$8.6 million until such time as Pervais either sold the securities or died, and that Squar approved this suggestion. They further alleged that Adler's initial function as a stockbroker under the Plan was to prepare and present to Squar a proposed stock and bond portfolio, that Adler presented such recommended portfolio, and that it was thereafter approved by Squar.

Respondents also alleged that the investment Plan never contemplated that the securities would be held for a long term, and that, in connection with setting up the Plan, Squar wrote a letter to Pervais saying "per your instructions, we need not worry too much about the replacement securities because any deferral will be short lived." Respondents alleged that during the operation of the Plan, Pervais talked with Adler frequently and made changes in the Plan from time to time; e. g., in early 1986 Pervais changed the Plan give Adler discretion to sell any ESOP security which had appreciated at least 24% and which Adler would otherwise recommend selling.

Respondents further alleged that the Plan never contemplated that the ESOP portfolio would be sufficiently hedged at all times to insure or guarantee it against losses in the event of a sudden major decline. The alleged that Adler's commitment was to exercise his best judgment and to buy puts if he believed that a downturn was likely and to buy calls when he considered a rising market, and that during the sixteen months prior to the crash, Adler had frequent discussions with Pervais in which Pervais expressed his feel for the market and the economy. Respondents argued that the 1987 crash was so sudden, unexpected and steep that Adler had no opportunity to take his customary steps to eliminate or reduce losses in the account.

Respondents also alleged that it was a material feature of the Plan that Pervais was to deposit substantial additional funds in the ESOP account as the installment payments became available to him which deposits would be applied to reduce the large margin debt. They argued that option hedging of a portfolio against downside risk is expensive and especially so when the portfolio is highly margined and that the Plan did not contemplate long-term hedging of the fully margined portfolio. They alleged that Pervais changed the Plan by deciding not to deposit the additional funds and by instructing Adler not to incur the expense of full hedging of the margined portfolio after the account moved to Cruttenden.

Respondents also alleged that Pervais, prior to the October 1987 market decline, elected to trade options and stocks on an unsolicited basis to try and decrease the margin debt balance, a strategy to which Adler objected orally and in at least one letter to Pervais.

Respondents also further alleged that when Pervais' ESOP account was being transferred from Kidder Peabody to Cruttenden, Adler and Pervais had an extended discussion in Florida regarding Pervais' revised investment objectives and that Pervais decided to reduce the hedging operation since the market had been on a constant rise and he regarded money

spent buying options that were intended to expire as money thrown away. They alleged that, on the other hand, Pervais regarded money earned by selling options or engaging in short term trading as "found money" and desired to increase such activity. They maintained that at the Florida meeting, Adler incorporated this change of objectives into the Cruttenden new account forms and reviewed them with Pervais who signed them after they had been completed, except for various dates and non-substantive information to be inserted later.

Respondents alleged that Pervais was a brilliant and sophisticated entrepreneur with exceptional experience in managing a large company with many technical employees and in investing in real estate and start up ventures and businesses. They added that Pervais was fully capable of understanding, and did understand, his investments, including his investments in the securities markets and that Squar even designed for Pervais, at Pervais' request, the forms of reports which Adler prepared monthly and quarterly and sent to both Squar and Pervais to enable them to fully monitor performance of the account under their Plan. They maintained that Pervais at no time gave any indication that he might be incapable of understanding, or did not understand, his account and that there was no way that Pervais could have failed to be aware of and understand the amount and kind of trading which occurred in his account from June 1986 to October 1987.

Respondents alleged that the market value of Pervais' investments declined sharply as a result of the October 1987 market crash, resulting in a series of margin calls; that instead of satisfying the calls with cash, which Pervais had available, he elected to liquidate securities, which forced him to knowingly incur capital gains tax.

Respondents alleged that Adler attended a meeting with Pervais, Squar and others in January 1988 to discuss Pervais' account at which meeting Adler explained the events surrounding the October 1987 market crash and sale of securities; no one at the meeting accused Adler of any wrongdoing and Squar indicated Pervais was not concerned with the losses he had suffered.

Relief Requested

In his Statement of Claim, Claimant requested:

1. Out-of-pocket losses of at least \$8,226,000.
2. Commission charges and margin interest;
3. Interest at the legal rate pre- and post- judgment;
4. Punitive damages of \$25,000,000.
5. Costs;
6. Attorney's fees;
7. Such further relief as deemed proper.

In Claimant's Closing Statement at the conclusion of the Hearing, Claimant requested compensatory damages of \$3,000,000 and argued that punitive damages in some amount would be appropriate but named no specific amount.

Respondents requested dismissal of all claims and recovery of their costs.

Other Issues Considered and Decided

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 the NASD.

Prior to the arbitration Hearing, Claimant dismissed: 1) all claims against Respondent Kidder Peabody & Co., Inc., 2) claims against Respondent Richard M Adler with respect to activities of Mr. Adler while he was employed at Kidder Peabody & Co., Inc., and 3) claims with respect to transactions in accounts other than the ESOP account. The matters remaining for determination by the panel at the Hearing were all of Claimant's ESOP-account claims against Respondent Cruttenden & Co and Claimant's ESOP-account claims against Respondent Richard A. Adler with respect to his activities during approximately twenty-two months from June of 1986 through August of 1988 while Claimant's account was maintained at Cruttenden & Co.

Respondents Cruttenden & Co.'s and Adler's motions to dismiss based on Section 15 of the Code of Arbitration Procedure and the applicable statutes of limitations were denied by the panel.

Respondents' made a motion for a determination that Claimant's expert witness, Richard Barrett, Jr., was not qualified to give the proposed expert testimony in this matter. Respondents' counsel conducted a voir dire examination of Mr. Barrett, and Claimant's counsel made an offer of proof as to what Mr. Barrett's testimony would be. The panel decided that, in all the circumstances, Mr. Barrett's testimony would not be helpful to the panel and would not be accepted and Mr. Barrett was excused without testifying.

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. Respondents Cruttenden & Co. and Richard Adler are jointly and severally liable for and shall pay to Claimant Mel M. Pervais the sum of \$1,550,000 in compensatory damages;
2. Each and every other claim is dismissed;
3. The claim for punitive damages is dismissed;
4. The parties shall each bear their respective attorney's fees;
5. The parties shall each bear their respective costs.

Other Costs

None.

Forum Fees

Pursuant to Section 43c of the Code of Arbitration Procedure, the following forum fees are assessed: The National Association of Securities Dealers, Inc., shall refund the \$1,500 hearing session deposit previously paid by the Claimant. Forum fees are assessed against respondent Cruttenden & Co. for \$30,300, calculated as follows:

Total forum fees assessed (one Prehearing session @ \$300/session, and 20 regular sessions @ \$1,500/session)	\$30,300
Claimant's assessment	0
Claimant's balance due	0
Respondent Cruttenden & Co.'s assessment	30,300
Respondent Cruttenden & Co.'s balance due	30,300

Adjournment fees of \$2,000 were assessed which have been paid.

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

Arbitration Panel

Name	Public/industry
Franklin G. Allen	Public
Edward W. Burnett	Public
Robert H. Hughes	Industry

Concurring Arbitrators' Signatures

Franklin G. Allen

Edward W. Burnett

Robert H. Hughes

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Date of Decision:

Other Costs

None.

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Concurring Arbitrators' Signatures



Franklin G. Allen

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Edward W. Burnett

Robert H. Hughes

Date of Decision:

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