

AWARD

NASD Regulation, Inc.

In the Matter of the Arbitration Between

Name of Claimants

Community Hospital of Springfield &
Clark County, Community Hospital
Retirement Plan & Clark County Dialysis Facility, Inc.

vs.

Name of Respondents

Kidder, Peabody & Co., Incorporated
David Beale

95-05939 &
95-05948 (Consolidated)

Name of Third Party Claimant

Kidder, Peabody & Co., Inc.

vs.

Name of Third Party Respondents

Ronald K. Benfield, Neal Kresheck,
Chris Brouhard, and Cherie Lamborn, Richard Foster,
Kristel Donner, Phillip L. Adamson, Hugh Barnett,
Charles Brougher, James Doyle, William Fippin, M.D.,
Alan Gabbard, M.D., Donald Jones, Reed Robertson,
Jane Scarff, George Walker, Pamela Young and Walter Kendig,
Individually and as Trustees of the Community Hospital

REPRESENTATION

For Claimants and Third Party Respondents Community Hospital of Springfield and Clark County, its Retirement Plan and Trustees: Bruce Sperling, Esq. and Steven J. Spitz, Esq., Sperling Slater & Spitz, Chicago, IL, and Jerry M. Santangelo, Esq., Neal, Gerber & Eisenberg, Chicago, IL

For Respondent and Third Party Claimant Kidder, Peabody & Co. Incorporated: Gregory J. Wallance, Esq., Jay G. Strum, Esq. and Andrew J. Melnick, Esq., Kaye, Scholer, Fierman, Hays & Handler, LLP, New York, NY

For Respondent David Beale: Samuel J. Beale, Esq. of Houston, TX

CASE INFORMATION

Statements of Claim filed: December 20, 1995

Trustees' Answer and Motion to Dismiss Kidder, Peabody & Co.'s Counterclaim and Third Party Claims
filed on: April 28, 1997

Community Hospital's Submission Agreement signed on: December 18, 1995

Clark County Dialysis Facility, Inc's Submission Agreement signed on: December 15, 1995

Community Hospital Retirement Plan's Submission Agreement signed on: December 18, 1995

Community Hospital Retirement Plan/TTEE's Submission Agreement signed on: January 9, 1996

Ronald K. Benfield's Submission Agreement signed on: January 9, 1996

Neal Kresheck's Submission Agreement signed on: January 9, 1996

Chris E. Brouhard's Submission Agreement signed on: January 9, 1996

Cherie J. Lamborn's Submission Agreement signed on: January 9, 1996

Richard Foster's Submission Agreement signed on: March 31, 1997

Kristel Donner's Submission Agreement signed on: April 2, 1997

Phillip L. Adamson's Submission Agreement signed on: April 2, 1997

Hugh Barnett's Submission Agreement signed on: March 31, 1997

Charles Brougher's Submission Agreement signed on: March 26, 1997

James Doyle's Submission Agreement signed on: March 25, 1997

William Fippin, M.D.'s Submission Agreement signed on: March 26, 1997

Alan Gabbard, M.D.'s Submission Agreement signed on: April 1, 1997

Donald Jones's Submission Agreement signed on: March 26, 1997

Reed Robertson's Submission Agreement signed on: March 31, 1997

Jane Scarff's Submission Agreement signed on: April 2, 1997

George Walker's Submission Agreement signed on: April 1, 1997

Pamela Young's Submission Agreement signed on: March 31, 1997

Walter Kendig's Submission Agreement signed on: March 28, 1997

Statement of Answer filed by Kidder, Peabody & Co., Inc. on: April 19, 1996

Kidder, Peabody & Co., Inc.'s Counterclaim and Third Party Claims against Community Hospital's
volunteers trustees filed on: November 15, 1996

Kidder, Peabody & Co., Inc.'s Submission Agreement signed on: March 28, 1996

State of Answer filed by David Beale filed on: April 12, 1996

David Beale's Submission Agreement signed on: April 12, 1996

HEARING INFORMATION

Pre-Hearing Conference Dates/Sessions: August 7, 1998/one session
 September 16, 1997/one session
 December 5, 1997/one session
 May 5, 1998/one session

Hearing Dates/Sessions: February 16, 1998/two sessions
 February 17, 1998/two sessions
 February 18, 1998/two sessions
 February 19, 1998/two sessions
 February 20, 1998/two sessions
 February 23, 1998/two sessions
 February 24, 1998/two sessions
 February 25, 1998/two sessions
 February 26, 1998/two sessions
 February 27, 1998/two sessions
 March 9, 1998/two sessions
 March 10, 1998/two sessions
 March 11, 1998/two sessions
 August 17, 1998/two sessions
 August 18, 1998/two sessions
 August 19, 1998/two sessions
 August 20, 1998/two sessions
 August 21, 1998/two sessions
 September 14, 1998/two sessions

Hearing Location: Columbus, Ohio

CASE SUMMARY

Claimants Community Hospital of Springfield and Clark County, a not-for-profit hospital located in Springfield, Ohio ("Community Hospital"), and its Pension Plan (collectively "Claimants") alleged that Respondents Kidder, Peabody and Company, Inc. ("Kidder") and Senior Vice President, David Beale ("Beale") breached their duties as securities professionals and violated numerous laws, including federal and state securities laws. Claimants alleged that Kidder and Beale (collectively "Respondents") breached their fiduciary duties and committed fraud in connection with their fraudulent and unsuitable recommended purchases and sales of CMO derivatives that caused Claimants to suffer significant losses.

Claimants alleged that prior to Kidder hiring Beale and his supervisors from Prudential Securities, Inc. ("Prudential") in July 1993, Beale had served as Community Hospital's investment advisor for eight years. Claimants asserted that Beale took Community Hospital from a ladder portfolio of certificates of deposit to highly volatile, esoteric collateralized mortgage obligations ("CMO") derivatives known as inverse floaters. Claimants further asserted that from mid-1991, Beale orchestrated a trading strategy with Community Hospital buying and selling inverse floaters, a strategy that made no economic sense other than to generate significant commissions for Respondents. Claimants alleged that at the time Kidder hired Beale, Kidder's senior managers reviewed Community Hospital's portfolio and thereby knew that Community Hospital represented over 85% of Beale's business. Claimants contended that Kidder

nevertheless hired Beale as a Senior Vice President and created a "Beale Bond Group" that operated in a separate, self-contained office, seven floors removed from Kidder's Houston branch office.

Claimants alleged that Kidder received a copy of Community Hospital's Board of Trustees' Corporate Resolution and Investment Guidelines, which set forth Community Hospital's investment objective "to provide for the safe investment of cash while maintaining liquidity to meet emergency and expected cash needs." Claimants contended that Kidder secretly rejected the Hospital's investment policy.

Claimants alleged that based on Kidder's advice, Community Hospital invested over 90% of its investible assets in Kidder's new issue CMO inverse floaters. Claimants asserted that such an enormously high concentration of inverse floaters violated Community Hospital's written investment guidelines and conservative investment objectives -- an extremely risky portfolio that made absolutely no sense. Claimants alleged that Kidder also misrepresented the nature and risk characteristics of these complex, highly risky, and extremely volatile "government-backed" bonds. Claimants also alleged that in two months of trading Community Hospital's assets, Kidder allegedly churned the account by turning Community Hospital's equity over 8 times to generate \$1.7 million in undisclosed commissions. Claimants further alleged that Kidder also obtained undisclosed, excessive and fraudulent mark-ups of \$4.5 million.

Claimants asserted that the NASD issued a Notice to Members in October 1993 reminding members of their suitability obligations in recommending CMO derivatives. The Reminder Notice specifically told its members that inverse floaters could only be recommended to "sophisticated investors with a high risk profile" who are specifically advised of the characteristics and risks of each inverse floater being recommended. Claimants contended that Community Hospital was not sophisticated, did not have a high risk profile and was not advised of the characteristics and risks of each inverse floater Kidder recommended.

Claimants alleged that in light of the NASD Notice, Kidder purportedly precluded Beale from trading CMO's to Community Hospital, yet failed to disclose such event to Claimants. Claimants alleged instead, that Kidder, at the highest levels of the firm, tracked Community Hospital's portfolio, which by then was constructed entirely of inverse floaters. Claimants further alleged that Kidder allowed \$12 million of pending inverse floater purchases to close in late November 1993, after its purported shut-down of Beale's CMO trading activity. Claimants contended that unbeknownst to them, Kidder's CMO Desk refused to support secondary sales of CMO inverse floaters as of September 1993.

Claimants alleged that Kidder allowed Beale to continue serving Community Hospital as an investment adviser, and Beale continued to recommend additional inverse floater transactions through the now defunct TDI, Inc./The Trading Desk (collectively "TDI"). Claimants contended that Beale recommended TDI could provide "good" inverse floaters to Community Hospital. Unbeknownst to Community Hospital, Claimants alleged that Beale received illicit commission payments from TDI which totaled hundreds of thousands of dollars, while still employed as Senior Vice President at Kidder.

Claimants alleged Community Hospital's portfolio of inverse floaters incurred a dramatic drop in value in 1994, when short term interest rates rose, and the inverse floater market that Kidder dominated fell precipitously. Claimants contended Community Hospital and its Pension Plan sought recovery from Kidder and Beale for its losses, plus the excessive mark-ups for Respondents' egregious, willful misconduct. Claimants further asserted that Kidder failed to properly supervise Beale's handling of Claimant's accounts.

Kidder denied all of Claimants' allegations and claims. Kidder asserted that the risks of investing in inverse floaters -- extension risk, coupon risk, liquidity risk and price volatility -- were disclosed to Richard Foster ("Foster") through offering circulars, Bloomberg analytics, yield and extension tables, and investor guides. Kidder further asserted that Foster, the CFO of Community Hospital, was an experienced and sophisticated CMO investor, having begun to invest in inverse floaters in March 1991, two and one half years prior to opening accounts at Kidder, Peabody. Kidder maintained that during this two and one half year period, Claimants made 127 inverse floater trades in an aggregate face amount exceeding \$100 million from Prudential and TDI. Kidder also maintained that Foster purchased \$7 million of CMO Z bonds from PaineWebber and Smith Barney.

Kidder further asserted that it satisfied its suitability obligations, as it had a reasonable basis to believe that Foster had the capacity to understand the risks of investing in inverse floaters and that Foster was making independent investment decisions. Kidder maintained that among other things, Claimants had substantial experience with inverse floaters prior to opening accounts at Kidder; had multiple consultants available to them, and had revised their investment guidelines to specifically list inverse floaters as an authorized investment before Claimants moved their accounts to Kidder in July 1993. Kidder further asserted that Claimants decided to concentrate their investments in inverse floaters before trading with Kidder, which lasted approximately six weeks.

Kidder contended that it closely supervised Beale, including imposing significant restrictions on his trading with Claimants. Kidder further asserted that after the NASD Special Notice 93-73 was circulated, Kidder informed Beale he could no longer sell inverse floaters to Claimants without conducting further due diligence. Kidder also maintained that after the Notice was published, Kidder did not sell any inverse floaters to Claimants.

Kidder denied liability for any trades Claimants effectuated through TDI in late 1993 and January 1994. Kidder maintained that it did not know of any such trades, was not aware of Beale's involvement in them and derived no benefit from them.

Kidder alleged, in its Third Party Claims against the Hospital and Retirement Plan Trustees, that if the panel found that the inverse floaters sold to Claimants were not suitable, then the Trustees breached their fiduciary duties by permitting the purchase of such securities in ignorance of such characteristics and risks. Kidder contended that as a result, under principles of contribution among joint tortfeasors, Kidder is entitled to contribution or indemnification from the Third Party Respondents for any award against Kidder. In addition, Kidder maintained that Claimants are not entitled to punitive damages.

In Response to Kidder's Counterclaim and Third Party Claims, Community Hospital's Trustees and the Hospital's Pension Plan Trustees denied that they breached their fiduciary duties and further denied any liability to Kidder, maintaining that contribution and/or indemnification is not available to an intentional tortfeasor such as Kidder. Also, the Trustees maintained that Kidder lacked standing to raise any such claims, and the Trustees owed no duty to Kidder. The Trustees requested that the claims against them be dismissed.

Respondent Beale denied the allegations of wrong-doing as asserted in the statements of claim. Beale maintained that his advice and predictions to Claimants were accurate and that Kidder was fully informed of the nature of his relationship with Community Hospital before he joined Kidder's Houston office. Beale further denied that CMOs were speculative or contrary to Claimants' investment objectives. Beale

maintained that Claimants were knowledgeable about the inverse floaters securities instrument from their first investments in that type of instrument prior to opening their account at Kidder. Beale contended that Claimants made their independent determination as to the suitability of the inverse floater for Claimants' investment purposes. Therefore, Beale maintained that any loss suffered by Claimants were the result of Claimants' own investment decisions.

RELIEF REQUESTED

Claimants requested \$19 million in compensatory damages, which includes losses on trades Claimants made at Kidder, as well as "lost opportunity" costs. Claimants also seek a punitive damages award equal to two times their compensatory damages. Claimants further requested that the Third Party Claims for indemnification and/or contribution be dismissed.

Kidder requested dismissal of Claimants' claims in their entirety. In the alternative, on its Third Party Claims, in the event of an award against it, Kidder seeks contribution from the Trustees for their breaches of duty that resulted in the losses on inverse floaters claimed by Claimants.

Beale requested that all claims asserted against him be dismissed.

OTHER ISSUES CONSIDERED & 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.

The panel considered the Motion to Consolidate arbitration cases 95-05039 and 95-05948 and the Responses thereto, and in September 1997 granted the Motion.

The panel accepted the parties' stipulation that all claims were resolved as to Prudential Securities, Inc., TDI, Inc., The Trading Desk, Inc. and Jerry Manning and that those parties were removed from the caption and from participation as a party in the proceedings. In addition, all claims as to Respondent Mary Cumberland were stayed due to bankruptcy.

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. That Respondents Kidder, Peabody & Co., Inc. and David Beale are jointly and severally liable to and shall pay to Claimants \$17,000,000.00 (seventeen million dollars); and
2. That Respondents Kidder, Peabody & Co., Inc. and David Beale are jointly and severally liable to and shall pay to Claimants \$4,500,000.00 (four million five hundred thousand dollars) in punitive damages; and
3. That Respondents Kidder, Peabody & Co., Inc. and David Beale are jointly and severally liable to and shall pay to Claimants post-award interest at ten percent (10%) per annum from the date the award is served by the NASD Regulation upon the parties; and
4. That Respondents Kidder, Peabody & Co., Inc. and David Beale are jointly and severally liable to and shall reimburse directly to Claimants \$15,000.00 for hearing session/interim forum fee deposits previously submitted to the NASD; and
5. That the Third Party Claims of Kidder, Peabody & Co., Inc. are denied in their entirety; and
6. That each party shall bear its own costs and expenses, including attorneys' fees, with the exception of forum fees as specified below; and
7. That any and all relief not specifically addressed herein is denied.

OTHER COSTS

Pursuant to Rule 10333 of the Code of Arbitration Procedure ("Code"), Respondent Kidder, Peabody was assessed a member surcharge of \$500.00 in each case, and Prudential and TDI were assessed a member surcharge of \$500.00 in the one case they were originally named in.

FORUM FEES

Rule 10332(b) of the Code defines a hearing session as any meeting between the parties and the arbitrators, including a pre-hearing conference, which lasts four hours or less. Pursuant to Rule 10332(c) of the Code, the following forum fees are assessed:

1 Prehearing Session (single arbitrator) x \$300.00 =	\$ 300.00
3 Prehearing Sessions (full panel) x \$1,500.00 =	\$ 4,500.00
38 Hearing Sessions x \$1,500.00 =	<u>\$57,000.00</u>
Total Forum Fees	\$61,800.00

That forum fees are assessed to Respondents Kidder, Peabody & Co., Inc. and David Beale, jointly and severally. Respondents shall receive credit for the \$13,400.00 previously submitted to the NASD, as well as the \$15,000.00 submitted by Claimants and ordered to be reimbursed directly to Claimants by Respondents, leaving a net balance due from Respondents of \$33,400.00.

Fees are payable to the NASD Regulation, Inc. Office of Dispute Resolution.

DATE

10/9/98

CONCURRING ARBITRATORS' SIGNATURES


Anne W. Larkin, Presiding Arbitrator
Public Arbitrator

Jeffrey M. Bain
Public Arbitrator

Robert P. Fogarty
Industry Arbitrator

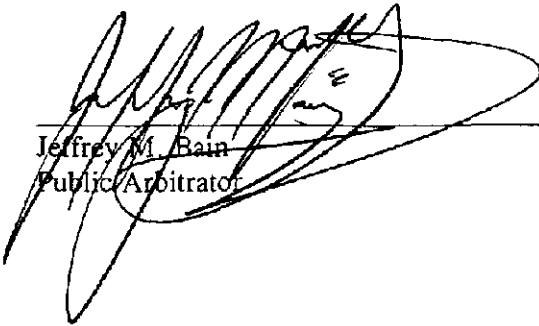
Date Decision Served by NASD Regulation: Oct. 16, 1998

DATE

CONCURRING ARBITRATORS' SIGNATURES

October 15, 1998

Anne W. Larkin, Presiding Arbitrator
Public Arbitrator



Jeffrey M. Bain
Public Arbitrator

Robert P. Fogarty
Industry Arbitrator

Date Decision Served by NASD Regulation:

Oct. 16, 1998

DATE

CONCURRING ARBITRATORS' SIGNATURES

Anne W. Larkin, Presiding Arbitrator
Public Arbitrator

Jeffrey M. Bain
Public Arbitrator

10-9-98

Robert P. Fogarty
Robert P. Fogarty
Industry Arbitrator

Date Decision Served by NASD Regulation:

Oct. 16, 1998