THE NATIONAL
LAW JOURNAL
MARCH 16, 2009
An ALM Publication

SECURITIES LAW

In debt crisis, an arbitration alternative

Investors have a stronger claim under rules established by a financial industry regulator.

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SPECIAL TO THE NATIONAL LAW JOURNAL

As the collapse of the nonprime mortgage markets has broadened into the worst financial crisis to confront this country in nearly a century, there is no shortage of theories of liability.

Mortgage lenders blame profligate homeowners who bought houses far beyond their means. Companies that purchased these loans, then packaged them into collateralized debt obligations (CDOs), decry the poor underwriting practices of the mortgage lenders. Investment banks saddled with the CDOs point to the lax standards of the ratings agencies that branded enormously risky securitized debt as safe investments.

Few litigants contesting the actions arising from the securitized debt disaster are aware of an emerging approach to resolving many of these disputes: arbitration under the rules of the newly constituted Financial Industry Regulatory Authority (FINRA), a body that oversees disputes involving members of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). With President Obama's appointment of Mary Schapiro, the former chief of FINRA, to head the U.S. Securities and Exchange Commission, this alternative method of dispute resolution under FINRA rules is likely to be the subject of increasing attention.

The finger-pointing that has erupted from the chaos in the financial markets has already generated a great deal of work for U.S. attorneys and courts. The new cases generally fall into three distinct camps.

First, there are suits brought on behalf of investors who purchased the stock of companies that failed to disclose the risks and losses associated with the overvalued mortgage-backed assets such CDOs and collateralized mortgage obligations (CMOs). Although these cases are usually brought as class actions, they also can be brought as individual actions by large investors who opt out of existing classes.

These shareholder suits are likely to prove expensive for defendants. In a May 2008 lawsuit, the State Retirement System of Ohio alleged that Merrill Lynch & Co. made false and misleading statements concerning its exposure to subprime debt, leading to shareholder losses. On Jan. 19, Merrill announced that it would pay $475 million to settle the suit. In re Merrill Lynch & Co. Inc. Sec., Derivative and ERISA Litig., No. MDL-1933 (S.D.N.Y).

Then there are actions brought on behalf of purchasers, usually institutions or pension funds, that bought interests in CDOs and CMOs via prospectuses. The plaintiffs pursuing these cases generally argue that the prospectuses contained false and misleading information, leading to their losses. Lastly, there are actions brought by plaintiffs who have directly purchased an interest in the income to be generated by securitized debt instruments. One example of this type of securitized debt case has recently piqued the interest of industry observers.

In HSH Nordbank A.G. v. UBS A.G., No. 08-600562 (New York Co., N.Y., Sup. Ct. filed Feb. 25, 2008), HSH sued UBS over the former's $500 million interest in a CDO. The profits HSH could make from its investment in the CDO turned on the high quality of the collateral in a reference pool. However, because of a credit default swap agreement between UBS and the CDO, UBS could benefit by placing bad loans in the reference pool.

Under their agreement, UBS got to pick what loans to include in the reference pool and what loans it could substitute into the pool. After the value of the CDO cratered, HSH filed suit, alleging that UBS had stacked the reference pool with bad loans for its own benefit.

HSH brought breach of fiduciary duty, breach of contract and other claims in New York state court, citing a forum selection clause in the reference pool side agreement. Its claim turned in part on HSH's assertion that it was an inexperienced customer with respect to the exotic CDOs sold by UBS.

On Oct. 21, 2008, the court permitted HSH's breach of contract claims to go forward, but rejected HSH's breach of fiduciary duty claim, pointing out that both parties to the transaction were large and sophisticated financial institutions involved in an arm's-length negotiation.

What HSH, like the plaintiffs in many of these cases, might not have realized was that it could have had stronger claims under FINRA rules. These rules have their origin in standards promulgated by the NASD, which includes almost all of the major sellers of structured finance products in the United States.

ARBITRATION ON DEMAND

For claims filed after April 16, 2007, § 10301(a) of the NASD rules, entitled "Required Submission," provides as follows, in pertinent part:

"Any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by and duly executed and enforceable written agreement or upon the demand of the customer."

Pursuant to NASD Code of Arbitration Rule 10301(d), this provision does not apply to class action claims. However, § 10301(a) provides for mandatory arbitration as against

any NASD member "upon the demand of the customer" even in the absence of a specific agreement to arbitrate.

In December 2007, the NASD Dispute Resolution Section merged with the NYSE Member Regulation Section to become FINRA. Thereafter, members of both the NASD and the NYSE agreed to have their arbitrations handled by FINRA. FINRA adopted many of the NYSE and NASD rules, and is in the process of preparing its own manual.

The arbitration code adopted by FINRA for cases filed after April 16, 2007, also requires arbitration against NASD members "upon the demand of the customer." NASD Rule 12000. It is clear that an action can be brought against a NASD member pursuant to this FINRA section even in the absence of an arbitration agreement. For example, in McMahan Securities Co. v. Aviator Master Fund Ltd., 20 Misc. 3d 386 (New York Co., N.Y., Sup. Ct. May 13, 2008), the trial court ordered the parties to arbitration and held that "[t]he NASD compels its members to arbitrate disputes with investors even where no direct transactional relationship or written agreement incorporating the NASD Code of Arbitration exists."

Shareholder lawsuits are likely to prove an expensive option.

Plaintiffs submitting their claims to FINRA arbitrators may benefit from substantive and procedural rules not available in courts of law. Securities arbitration panels often hear and decide cases based not upon common law or statutory rules but upon various NASD rules that have been, in certain cases, acknowledged by courts of law. Principal among these are the "suitability" and "know your customer" rules. The suitability rule, NASD Rule 2310, provides that:

"In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

U.S. courts frequently cite this rule in analyzing "suitability" cases brought under the U.S. securities laws. See, e.g., GMS Group LLC v. Benderson, 326 F.3d 75, 82 (2d Cir. 2003).

The NYSE's "know your customer rule," Rule 405, which has been adopted under the FINRA rules, is even broader. Rule 405 provides in relevant part that: "Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [¶2342] to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."

Like the unsuitability rule, this rule is frequently cited and relied upon by U.S. courts. See, e.g., Gabriel Capital L.P. v. Natwest Finance Inc., 137 F. Supp. 2d 251, 263 (S.D.N.Y. 2000) (holding that a violation of this "has been held to constitute a violation of the federal securities laws"). Thus, even an apparently sophisticated banking institution like HSH may be able to take advantage of these rules that impose a burden upon the seller of a security or obtain knowledge concerning the buyer's needs.

In addition, to the "suitability" and "know your customer" rules is the NASD "Standards of Commercial Honor and Principles of Trade," NASD Rule 2110, which governs all conduct even among sophisticated parties. It states simply that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

This rather vague rule has been invoked by arbitration panels to remedy otherwise improper conduct even when there is little support for claims of misconduct under conventional legal rules.

One potential benefit to plaintiffs in this process is that disputes subject to resolution under FINRA rules can rarely be rejected upon a motion to dismiss. The application of these rules virtually compels a detailed, fact-specific inquiry, and thus often drives the proceedings toward a factually intensive battle regarding the sophistication of the parties and "who said what to whom."

Another reason why plaintiffs are more likely to get full hearings of their cases under FINRA rules stems from the scope of appeals from arbitration decisions. The controlling law for the arbitration of securities-related claims is the Federal Arbitration Act, 9 U.S.C. 1-14, which provides that an arbitration award may be set aside only for very limited reasons. Antwine v. Prudential Bache Securities Inc., 899 F.2d 410, 413 (5th Cir. 1990) (holding that "[j]udicial review of an arbitration award is extraordinarily narrow").

A district court has no authority to vacate an arbitration award unless the award was procured by corruption, fraud or undue means; there is evidence of partiality or corruption among the arbitrators; the arbitrators were guilty of misconduct that prejudiced the rights of one of the parties; or the arbitrators exceeded their powers. 9 U.S.C. 10(a)-(d).

Arbitration allows relaxed evidentiary rules and appeals.

Under the factor relating to arbitrator misconduct, a failure to grant parties an adequate opportunity to present their evidence is grounds for a district court to set aside an arbitration award. See, e.g., Forsythe Int'l S.A. v. Gibbs Oil Co. of Texas, 915 F.2d 1017, 1020 (5th Cir. 1990).

Thus, not only relaxed evidentiary rules but the statutory grounds for appeal create a strong incentive to give a full and open hearing to all facts relevant to a case subject to arbitration. This means that although a defendant-seller of a structured finance vehicle might have strong legal defenses, the odds are high that it can only prevail after a hearing at which there is live testimony concerning the underlying transaction.

While it remains to be seen whether FINRA arbitration becomes broadly adopted as a way to resolve the rapidly multiplying securitized debt disputes, there can be little doubt of the appetite for exploring such novel approaches in the years of litigation that lie ahead. NLJ

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