BRESSLER, AMERY & ROSS
A PROFESSIONAL CORPORATION

SECURITIES LAW ALERT

JULY 1, 2012

New Jersey Appellate Division Holds That A FINRA Member Firm Is Not Required To Arbitrate A Third Party Claim For Contribution And Indemnification Brought By Another Member Firm in A Customer Initiated Arbitration Where There Is No Agreement To Arbitrate Between The Member Firms And The Dispute Does Not Involve A Covered, Exchange Related Transaction

By: David J. Libowsky

A. Introduction

The New Jersey Appellate Division has just ruled that contrary to conventional wisdom, not all disputes between members of the Financial Regulatory Authority ("FINRA") are subject to mandatory arbitration. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. et al. v. Cantone Research, Inc. et al.*, 2012 N.J. Super. LEXIS 112, Docket No. A-2680-10T1, A-2682-10T1, A-2699-10T1 (App. Div. June 27, 2012), the Appellate Division addressed the arbitrability of third party claims for contribution and indemnification that were asserted by J.J.B. Hilliard, W.L. Lyons, LLC ("Hilliard Lyons"), PNC Investments, LLC ("PNC") and Cantone Research, Inc. ("Cantone") (Hilliard Lyons, PNC and Cantone are hereinafter sometimes collectively referred to as the "Broker-Dealer Defendants") against Merrill Lynch, Pierce, Fenner and Smith Incorporated ("Merrill Lynch") in arbitrations before FINRA Dispute Resolution. These arbitrations were initiated by customers of the Broker-Dealer Defendants who were allegedly defrauded by a registered representative employed by those firms. The registered representative, who had used his personal securities account with Merrill Lynch to effectuate his fraudulent scheme, was never employed by Merrill Lynch. In what appears to be a case of first impression, the Appellate Division held that Merrill Lynch was not required to arbitrate the third party claims under the FINRA By-Laws, the FINRA Dispute Resolution Code of Arbitration Procedure for Customer Disputes (the "Customer Code") or the FINRA Dispute Resolution Code of Arbitration Procedure for Industry Disputes (the "Industry Code"). *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at **17-23. As a result, the Appellate Division affirmed the trial court's order preliminarily enjoining the Broker-Dealer Defendants from proceeding with the third party claims in the customer arbitrations and denying their cross-motion to compel arbitration. *Id*. at **23-24.

The decision in *Merrill Lynch* is significant as it concludes that a FINRA member firm is not required to arbitrate *all* disputes with other member firms merely because of its status as a FINRA member firm. Instead, a member firm must arbitrate a claim asserted by another member firm -- including but not limited to a third party claim for contribution and indemnification -- only where there is an agreement to arbitrate disputes or the claim involves a "covered, exchange-related transaction." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at **17-20.

B. The Frederick Litigation

The Appellate Division's decision in *Merrill Lynch* arises out of a Ponzi scheme conducted by Maxwell Smith ("Smith"), an associated person who was employed by a number of broker-dealers, including Hilliard Lyons, PNC and Cantone. Smith used the account which he maintained with Merrill Lynch to conduct the Ponzi scheme, defrauding 10 customers of approximately $8 million over a period of 17 years. Smith, however, was not a registered representative of or otherwise employed by Merrill Lynch. The defrauded investors commenced actions against

(among others) Merrill Lynch and the Broker-Dealer Defendants to recover their monies. Four actions were filed against Merrill Lynch and the Broker-Dealer Defendants in New Jersey Superior Court, consolidated under the caption *Leonard Frederick, et al. v. Maxwell Baldwin Smith, et al.*, Docket No. MRS-L-1108-09 (the plaintiffs in the New Jersey Superior Court actions are hereinafter collectively referred to as the "Frederick Plaintiffs"). A fifth action was filed against Merrill Lynch and Cantone (but not Hilliard Lyons and PNC) in the United States District Court for the District of New Jersey, captioned *Ralph Tedeschi, et al. v. Maxwell B. Smith III, et al.*, Civil Action No. 09-03134 (the plaintiffs in the District of New Jersey action are hereinafter collectively referred to as the "Tedeschi Plaintiffs") (the Frederick Plaintiffs and the Tedeschi Plaintiffs are hereinafter collectively referred to as the "Investor Plaintiffs"). The Investor Plaintiffs, none of whom were customers of Merrill Lynch, each alleged claims against Merrill Lynch for negligent supervision of the Smith Account. *See generally, Frederick v. Smith*, 416 N.J. Super. 594, 597 and 601 (App. Div. 2010). The Honorable W. Hunt Dumont, P.J.S.C. dismissed the Frederick Plaintiffs' claims against Merrill Lynch, holding that because the plaintiffs were not customers of Merrill Lynch, Merrill Lynch did not owe any duty to them. Judge Dumont also compelled the Frederick Plaintiffs' claims against Cantone, Hilliard Lyons and PNC to arbitration before FINRA Dispute Resolution. The Honorable Joel A. Pisano, U.S.D.J. reached the same result in the federal court action, dismissing the claims against Merrill Lynch because it found that Merrill Lynch did not owe a duty to non-customers. Additionally, the court ordered the Tedeschi Plaintiffs to arbitrate their claims against Cantone before FINRA Dispute Resolution. *See generally Tedeschi v. Smith*, 2010 U.S. Dist. LEXIS 2336 (D.N.J. Jan. 12, 2010).

The Frederick Plaintiffs appealed the dismissal of their claims against Merrill Lynch (the Tedeschi Plaintiffs, however, did not appeal the dismissal of their claims). On November 9, 2010, the Appellate Division affirmed the trial court's dismissal of the Frederick Plaintiffs' claims against Merrill Lynch, holding that "[b]ecause plaintiffs had no relationship with Merrill Lynch, and because Smith had no relationship with Merrill Lynch other than as owner of the account into which the funds were placed, we conclude that, as a matter of law, no duty should be imposed on Merrill Lynch to periodically examine the account's activities for indicia of fraud...." *Frederick*, 416 N.J. Super. at 597. The Appellate Division held further that "the absence of any relationship between plaintiffs and Merrill Lynch precludes the imposition of a duty on Merrill Lynch to periodically or regularly police the personal account maintained by Smith for indicia of fraud." *Id*. at 601.

C. The Broker-Dealer Defendants' Third Party Claims Against Merrill Lynch In The Investor Plaintiffs' Arbitrations.

Subsequent to filing their appeal from Judge Dumont's dismissal of their claims against Merrill Lynch (but prior to the Appellate Division's decision in *Frederick*), the Investor Plaintiffs commenced arbitrations against the Broker-Dealer Defendants before FINRA Dispute Resolution. The Broker-Dealer Defendants, in turn, filed third party claims for indemnification and contribution (the "Third Party Claims")

against Merrill Lynch and the financial advisor who serviced the Smith account during the last few years that Smith was conducting his Ponzi scheme (Merrill Lynch and the financial advisor are hereinafter collectively referred to as "Merrill Lynch"). Merrill Lynch commenced actions in New Jersey Superior Court to enjoin the Broker-Dealer Defendants from proceeding with the Third Party Claims. The Broker-Dealer Defendants cross-moved to compel arbitration. On December 20, 2010, Judge Dumont entered orders preliminarily enjoining the Broker-Dealer Defendants from arbitrating the Third Party Claims and denying their cross-motion to compel arbitration. Judge Dumont first held that the trial court, and not the arbitrators, had the authority to determine whether Merrill Lynch was required to arbitrate the Third Party Claims. Judge Dumont held further that Merrill Lynch was not required to arbitrate these claims because (i) there was no agreement between Merrill Lynch and the Broker-Dealer Defendants requiring that the Third Party Claims be arbitrated; and (ii) neither the Customer Code nor the Industry Code mandated arbitration of these claims.

D. The Appellate Division's Decision

The Broker-Dealer Defendants appealed Judge Dumont's orders enjoining the Third Party Claims and denying the cross-motion to compel arbitration. On June 27, 2012, the Appellate Division affirmed the trial court's order, agreeing with its decision in all material respects. The Appellate Division panel (Judges Cuff, Waugh and St. John) held that the trial court correctly concluded that it, and not the arbitrators, had the authority to determine the arbitrability issue, finding that the question whether Merrill Lynch was obligated to arbitrate the Third Party Claims is a "gateway dispute" and an issue involving "substantive arbitrability" which was for the trial court to determine. *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at **16 and 23. The Appellate Division held further that Judge Dumont correctly determined that Merrill Lynch was not required to arbitrate the Third Party Claims because (i) there was no agreement between Merrill Lynch and the Broker-Dealer Defendants; and (ii) these claims are not "exchange-related disputes." *Id*. at **17-20.

The Appellate Division found no support for the Broker-Dealer Defendants' contention that "simply because Merrill Lynch and defendants are all FINRA members, they have somehow consented to arbitration for *all* claims that arise between them." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at *19 (emphasis in original). The court held that "the Merrill Lynch account was used by Smith as a personal depository of funds," concluding that "Defendants have failed to demonstrate that Merrill Lynch was acting in any way as a broker-dealer for any of the parties or that it engaged in a covered, exchange-related transaction with any defendant." *Id*. The Appellate Division held further that the trial court correctly concluded that the Third Party Claims for contribution and indemnification were not industry disputes subject to the Industry Code. The court found that the basis for these claims "was not a dispute between industry members, as it was derivative in nature and contingent on the initial dispute between defendants and the investors, defendants' customers." *Id*. at **20-21. Nor does the Customer Code require Merrill Lynch to arbitrate the Third Party Claims, as "neither defendants nor the investors are customers, as defined by the Customer Code, of Merrill Lynch." *Id*.

The Appellate Division held further that the trial court correctly concluded that the Third Party Claims for contribution and indemnification were not industry disputes subject to the Industry Code.

The Appellate Division's decision in Merrill Lynch is significant because it is the first reported decision which has held that a member firm does not have an unlimited obligation to arbitrate disputes with other member firms.

The Appellate Division rejected the argument that Merrill Lynch was required to arbitrate the Third Party Claims merely because they were claims asserted by other FINRA members, concluding that "Defendants fail to point to any section of the FINRA Code of Arbitration Procedure that expressly indicates that 'any and all' disputes between member firms must be submitted to arbitration; particularly those initiated for contribution and indemnification from a member with whom the party seeking arbitration had no agreement to arbitrate." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at *20. Further, the court held, the Broker-Dealer Defendants failed to cite any section of the FINRA By-Laws "that binds a member exclusively to arbitration for all disputes." *Id*. In this regard, the *Merrill Lynch* panel observed, if the By-Laws in fact intended for member firms to arbitrate all disputes amongst one another, the sections of the Customer and Industry Codes setting forth when customers and member firms must arbitrate "would not seem necessary." *Id*.

The court rejected the Broker-Dealer Defendants' argument that its decision "forever brand[s]" third party claims for contribution and indemnification as "derivative," finding that this assertion is "speculative" in light of the fact that "defendants have not attempted to file a complaint against plaintiffs in the Law Division." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at *22. In this regard, the panel observed that "[t]o the extent defendants have a viable claim against Merrill Lynch that is not purely derivative of the claims by the investors that have already been dismissed, nothing in *Frederick* or in this opinion prevents them from pursuing it in the Law Division." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at *22, n. 9. The court also rejected defendants' argument that the issue presented is one of joinder under the Customer Code, which is procedural in nature and thus for the arbitrators to decide. The *Merrill Lynch* panel held that "by allowing defendants to join plaintiffs as third party defendants in the investor-initiated arbitrations, such a concession would strip the courts of its authority to determine gateway issues, such as whether the parties are bound by an arbitration clause or whether a binding contract applies to a particular controversy." *Id*. at *23.

Finally, the Appellate Division affirmed the trial court's decision to preliminarily enjoin the Broker-Dealer Defendants from proceeding with the Third Party Claims, agreeing with the trial court's finding that Merrill Lynch would be irreparably harmed "by being subject to defending arbitration actions not required by the FINRA Codes." *Merrill Lynch,* 2012 N.J. Super. LEXIS 112 at *24. Finding further that the defendants had not shown that they "face immediate and irreparable harm," the court "[saw] no reason to disturb Judge Dumont's grant of injunctive relief." *Id*.

E. Conclusion

The Appellate Division's decision in *Merrill Lynch* is significant because it is the first reported decision which has held that a member firm does not have an unlimited obligation to arbitrate disputes with other member firms. Under *Merrill Lynch*, a member firm can be required to arbitrate a claim brought by another member firm -- including but not limited to a third party claim for contribution and indemnification -- only where there is an arbitration agreement between the parties or the member firm respondent has engaged

in a "covered, exchange-related transaction." *Merrill Lynch*, 2012 N.J. Super. LEXIS 112 at **17-20. Absent such an arbitration agreement or exchange-related transaction, a member firm will not be able to rely on either the FINRA By-Laws or the Customer or Industry Codes to compel the other member firm to arbitrate its claim. Instead, the member firm will be required to seek relief in a judicial forum, where the claim will be subject to the rules governing actions filed in that forum, *i.e.*, rules permitting dispositive motions such as motions to dismiss for failure to state a claim and for summary judgment, instead of the rules governing claims filed in arbitration before FINRA Dispute Resolution. ■

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

David J. Libowsky
dlilbowsky@bressler.com
973.660.4423