Failing to Pay a FINRA Arbitration Award: The Good, The Bad and The Ugly

Ethan A. Brecher, New York Law Journal
October 4, 2017 | 0 Comments

Ethan A. Brecher
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The consequences to a Financial Industry Regulatory Authority (FINRA) registered representative for not paying an adverse arbitration award can be career-threatening. FINRA is empowered to suspend from its association any representative who fails to pay an arbitration award until it is paid. Despite this drastic consequence, non-payment of arbitration awards is a significant on-going problem for FINRA. Thus, at its July 18, 2017 Board of Governors meeting, FINRA's Board authorized new rules to remedy the problem. The Board approved the publication of a Regulatory Notice soliciting comment on proposed amendments to FINRA's Membership Application Program rules to provide FINRA staff with rule-based authority to presumptively deny a new membership application if the applicant or its associated persons are subject to pending arbitration claims. In addition, the proposed amendments would require a member firm to seek a materiality consultation with FINRA if the member is not otherwise required to file a continuing membership application and the member is seeking to effect a business expansion or asset transfer and the member or an associated person has a substantial level of pending

arbitration claims, an unpaid arbitration award or an unpaid settlement related to an arbitration. (As of the date of this article the Regulatory Notice detailed above has not been published.)

It can therefore be expected that not only will FINRA proceed with the rulemaking process to enhance its ability to compel members and representatives to pay arbitration awards, but also that FINRA's enforcement division will redouble its efforts to use existing rules to suspend representatives who fail to pay arbitration awards.

FINRA wields tremendous power over the 631,394 registered representatives who work for or with the 3,789 firms that make up its membership. (FINRA Statistics as of July 2017.) The most direct manifestation of that power (apart from licensing those individuals) comes from FINRA's ability to discipline representatives using monetary fines, suspension and expulsion from association with FINRA. FINRA is authorized to investigate, prosecute and impose sanctions for a broad array of misconduct on the part of individual representatives, including when they fail to pay arbitration awards, participate in unauthorized outside business activities, commit forgery, misuse funds and otherwise engage in prohibited activities in connection with the purchase and sale of securities. See FINRA Sanctions Guidelines, April 2017.

Between 2012 and 2016 FINRA received 14,341 customer complaints, filed 7,419 new disciplinary actions, expelled 127 and suspended 94 member firms, barred 2,217 representatives from membership, and suspended 3,387 representatives from membership. (FINRA Statistics as of July 2017.)

In the same 2012-2016 time-period customers, representatives and firms, using FINRA's arbitration forum, filed 18,951 new arbitrations. (One of FINRA's main activities is the administration of an arbitration forum. Virtually all customers are required either as a condition of doing business with a member firm or representative, or of a representative being employed by a member firm, is to submit all disputes to binding arbitration at FINRA.) During those years a total of 20,337 arbitration cases were closed either though awards from arbitrators, settlements or otherwise. Thus, for a registered representative, there is a substantial risk that sometime during his/her career a dispute will arise with FINRA, a customer or member firm (the most common category of dispute from 2013-July 2017 between member firms and their representatives involved promissory notes, with 2,069 cases being filed, followed by 1,809 breach of contract

cases) that will result in adverse action being taken against his/her securities license.

In situations where registered representatives lose an arbitration case (customers win around 41 percent of the time in FINRA arbitrations where awards are issued, and member firms win nearly all the promissory note cases against representatives), they must pay the arbitration award within 30 days to avoid being fined, suspended or expelled from membership with FINRA.

FINRA Rule 9554 contains expedited suspension procedures that address a brokerage firm's or representative's failure to pay FINRA arbitration awards. FINRA can suspend or cancel the registration of a representative or brokerage firm if that party does not comply with an arbitration award or settlement related to an arbitration or mediation. However, a brokerage firm or representative may assert four defenses to the expedited suspension process: (1) the brokerage firm or broker paid the award in full; (2) the parties have agreed to installment payments or have otherwise settled the matter; (3) the brokerage firm or broker has filed a timely motion to vacate or modify the award and such motion has not been denied; and (4) the brokerage firm or broker has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award has been discharged by the bankruptcy court. FINRA Regulatory Notice 10-31.

Before July 2010 a representative was also allowed in cases brought by customers to assert as a defense to charges brought under Rule 9554 that he/she had an inability to pay the arbitration award due to lack of financial resources. FINRA changed the rules in July 2010 and eliminated the inability to pay defense in cases brought by customers. FINRA explained the rule change in its Regulatory Notice 10-31 as follows: “expedited proceedings under Rule 9554 use the leverage of a potential suspension to help ensure that a firm or an associated person promptly pays a valid arbitration award. However, if a respondent demonstrated a financial inability to pay the award—regardless of the reason—the leverage was removed. When FINRA’s efforts to suspend a respondent who had not paid an award were defeated, a claimant was much less likely to be paid.” Thus, to try and maximize the chances of a broker satisfying an arbitration award, FINRA eliminated the ability of a broker to claim he couldn’t afford to pay the award.

Buried in a footnote of the same 10-31 Notice was FINRA’s response to the broker who asserted that he could not pay the arbitration award—go file for

bankruptcy. FINRA noted: “Bankruptcy judges are experts in evaluating whether a debtor’s obligations should be legally discharged. The bankruptcy process and associated filings are designed to consider fully and evaluate the financial condition of bankruptcy debtors. … In addition, bankruptcy filings, which are subject to federal perjury charges, provide greater penalties for hiding assets.” FINRA thus judged that brokers would be less likely to try and skirt paying awards if the alternative was to file for bankruptcy protection.

The inability to pay defense, however, remains a valid defense in any proceeding brought under Rule 9554 regarding arbitrations as between member firms and representatives, such as in cases involving promissory notes and where a member firm might seek indemnification payments from the representative.

While the inability to pay defense is viable, it is not easy to establish. In a Rule 9554 proceeding where a representative asserts the defense, all of his financial records become subject to discovery by FINRA. (Failure to produce any of the documents FINRA requests in discovery can result in a separate failure to cooperate charge, which can also result in the representative being suspended or expelled.)

A representative is permitted to appeal any adverse outcome in a Rule 9554 proceeding to the Securities & Exchange Commission (SEC). As the SEC explained recently in dismissing an appeal from a representative suspended by FINRA for failing to pay an arbitration award on grounds that he failed to prove an inability to pay defense: “To prevail on an inability-to-pay defense a respondent must demonstrate that he is unable to make some meaningful payment toward the award from available assets or income. The party arguing inability to pay has the burden of proving the defense, because the scope of his assets is peculiarly within his knowledge. A FINRA Hearing Officer may make a rigorous inquiry into a respondent’s inability to pay.” In the Matter of Michael Albert DiPietro, Release No. 77398 (S.E.C. Release No.), Release No. 34-77398, 2016 WL 1071562 (March 17, 2016). The SEC also noted that a respondent cannot succeed on an inability to pay defense if he can divert funds from other expenses to make some meaningful payment towards satisfaction of the award even if cannot pay the full amount, and that the defense is unavailable if a respondent can borrow against assets (or even family members) to satisfy the award or pay a meaningful part of it.

The 'DiPietro' Case

The most recent reported instance of the SEC addressing the inability to pay defense involves a broker named Michael DiPietro, who was suspended in 2015 by FINRA and whose appeal was dismissed by the SEC in March 2016.

In 2004, DiPietro and First Allied Securities entered into an Independent Contractor Agreement (ICA), which provided that DiPietro would sell securities and other services on behalf of First Allied. The ICA also included a broad provision under which DiPietro agreed to indemnify First Allied for losses, costs, and expenses related to disputes arising out of the agreement. On Sept. 19, 2012, a client named Martina Hutchinson filed a claim against First Allied in a FINRA arbitration related to investments purchased through DiPietro and First Allied. Pursuant to FINRA rules, the arbitration was assigned to Phoenix, Arizona. First Allied filed an answer and a third-party claim against DiPietro seeking indemnification under the ICA. DiPietro filed a response and counterclaims against First Allied for abuse of process and malicious prosecution. Hutchinson's claims against First Allied were settled.

The arbitration between First Allied and DiPietro continued, resulting in a unanimous three-member panel decision in favor of First Allied. The panel found that DiPietro was liable to First Allied for $100,000 in compensatory damages, post-judgment interest at the rate of 8 percent, $56,047.55 in attorney fees, and $1,456.24 in witness fees. DiPietro's counterclaims were denied. DiPietro v. First Allied Sec., CV-14-00502-PHX-DGC, 2017 WL 1233812, at *1 (D. Ariz. April 4, 2017). On March 12, 2014, DiPietro filed a motion with the federal district court in Arizona to vacate or modify the arbitration award. The court denied the motion and confirmed the arbitration award and the Ninth Circuit affirmed. DiPietro v. Hutchinson, CV-14-00502-PHX-DGC, 2014 WL 4954410 (D. Ariz. Oct. 1, 2014), affd sub nom. DiPietro v. First Allied Sec., 669 Fed Appx 927 (9th Cir. 2016). First Allied was awarded by the court an additional $75,000 in legal fees for defending against the appeal.

As DiPietro was challenging the arbitration award in court, FINRA began proceedings in 2014 to suspend his securities license until he paid the award or could establish a recognized defense to non-payment. FINRA held a hearing in the winter of 2015 and the FINRA hearing officer presiding over the case found that DiPietro failed to establish an inability to pay the award or any of the other enumerated defenses in a Rule 9554 proceeding. DiPietro appealed to the SEC, but his appeal was dismissed in

March 2016.

The SEC in its Order affirming FINRA's decision to suspend DiPietro found that he had sufficient gross income in 2014 through other income producing activities to pay the award. Further, the SEC found that he used his income to pay discretionary expenses rather than paying the award, such as reducing the principal on his home mortgage, making payments for more than the minimum on credit cards and student loans for his children, paid for a private high school for his child, made monthly gifts to an adult child to supplement his income, and made payments for car insurance for another adult child. Further, the SEC concluded that he had equity in various properties which he could have borrowed against to pay the award. Taken together, these facts led the SEC to conclude that DiPietro had failed to establish an inability to pay defense.

As the DiPietro case shows, a representative faces a significant hurdle in establishing the inability to pay defense. This leaves the difficult option of a bankruptcy filing to stop the Rule 9554 case from proceeding, or filing motion in court to vacate an arbitration award. There are limited grounds for doing so and most applications to vacate are unsuccessful (in the Second Circuit only four arbitration awards since 1960 have been vacated for being in manifest disregard of the law out of 48 cases where the court has considered the issue). Wallace v. Buttar , 378 F.3d 182, 191 (2d Cir. 2004). Indeed, as explained in a recent federal court decision, "judicial review of an arbitration award in federal court is severely circumscribed. [S]uch review as among the narrowest known at law . … [A] court sits to determine only whether the arbitrator did his job—not whether he did it well, correctly, or reasonably, but simply whether he did it. Thus, as long as the arbitrator is even arguably construing or applying the contract and acting within the scope of his authority, that a court is convinced he committed serious error does not suffice to overturn his decision." Interactive Brokers, Plaintiff v. Rohit Saroop, Preya Saroop, and George Sofis, Defendants, 3:17CV127, 2017 WL 3841883, at *5 (E.D. Va. Sept. 1, 2017).

Thus, for FINRA representatives who owe money to their former employers pursuant to arbitration awards, the good news is that they can invoke an inability to pay defense to a case brought by FINRA under Rule 9554. The bad news is that this defense is extremely difficult to establish and the SEC has made it clear that representatives will have little latitude to avoid suspension if they have any resources to pay some part of the award. The

ugly part is that a representative may spend a lot time, effort and money defending against a claim and pursuing his legal remedies, all of which are subject to some of the most exacting and narrow standards of review known to the law. This means that the odds of a favorable outcome are low, absent a smart strategy to come to a resolution that may leave nobody happy, but will allow the representative to continue in his/her chosen profession.

Ethan A. Brecher, the founder of Law Office of Ethan A. Brecher, can be reached at ethan@ethanbrecherlaw.com