# SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PRESENT: KORNREICH Justice

PART 54

MCMAHAN SECURITIES

- v -

AVIATOR MASTER FUND

INDEX NO. 603161/07

MOTION DATE 11/29/07

MOTION SEQ. NO. 1

MOTION CAL. NO.

The following papers, numbered 1 to 10 were read on this motion to/for Stay Arbitration

| | PAPERS NUMBERED |
|---|---|
| Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ... | 1-5 |
| Answering Affidavits — Exhibits | 6-9 |
| Replying Affidavits | |

FILED

MAY 16 2008

COUNTY CLERK'S OFFICE
NEW YORK

**Cross-Motion:** ☐ Yes ☑ No

Upon the foregoing papers, it is ordered that this motion

**MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION AND ORDER.**

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 5/12/08

HON. SHIRLEY WERNER KORNREICH

J.S.C.

Check one: ☑ FINAL DISPOSITION ☐ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 54

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McMAHAN SECURITIES CO. L.P.,

Petitioner,

-against-

AVIATOR MASTER FUND, LTD., AVIATOR OVERSEAS FUND II, LTD., JMG TRITON OFFSHORE FUND, LTD., JMG CAPITAL PARTNERS, L.P., LONGVIEW EQUITY FUND, L.P., LONGVIEW INTERNATIONAL EQUITY FUND, L.P., WHITEBOX CONVERTIBLE ARBITRAGE PARTNERS, L.P., and WHITEBOX HEDGED HIGH YIELD PARTNERS, L.P.,

Respondents.

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Index No.: 603161/07

DECISION
and ORDER



KORNREICH, SHIRLEY WERNER, J.:

Petitioner brings this proceeding, pursuant to CPLR § 7503, to stay an arbitration claim brought before the NASD. The claim arises out of a private placement transaction for the purchase of securities offered and sold to respondents by non-parties Strategy Real Estate Investments, Ltd. (SREI) and Strategy International Insurance Group, Inc. (SIIG), collectively "Strategy"). Respondents oppose this petition.

*I. Background*

Petitioner McMahon Securities Co., L.P. (McMahon) is a securities broker-dealer and Financial Industry Regulatory Authority (FINRA or NASD) member.[1] Respondents are hedge funds and institutional investors. Non-party SIIG is a publically traded holding company for several financial service companies. Non-party SREI is a wholly-owned subsidiary of SIIG

[1]FINRA was formed on or about July 30, 2007 taking over the regulatory functions of the NASD and New York Stock Exchange. FINRA has incorporated NASD's rules and regulations.

formed for the purpose of making investments in residential real estate developments in Canada.

The chronology and character of the transactions are not in dispute. On or about September 23, 2004, McMahon entered into an agreement with SREI to serve as its placement agent[2] (the Strategy Contract) in SREI's offering to sell $50 million worth of preferred stock units to qualified institutional investors (the Offering). Each unit was composed of: one share of SREI Series A Insured Redeemable Preferred Stock; one share of SREI Series B Preferred Stock; and a warrant to purchase shares of SIIG common stock. Each unit was valued at $10,000. The Series A Shares were to pay a quarterly dividend of 10% per annum until a mandatory redemption of the shares in November 2007. In the event two consecutive dividend payments were missed, Strategy would be liable for all accrued and unpaid dividends plus an amount equal to the entire liquidation preference for the Series A shares, which amounted to the total purchase price paid for the units. This liquidation preference and quarterly dividends were guaranteed and insured by United Insurance Company.

The Strategy Contract called for Strategy to compensate McMahon as follows: an up-front engagement fee of $50,000; 5% of the total proceeds from units sold in the Offering; a five-year warrant to purchase Strategy common stock equivalent to 5% of the total principal arising from all units sold in the Offering; and reimbursement of up to $25,000 in expenses. The Strategy Contract described in great detail the rights and obligations of the parties. It specifically noted that "McMahon shall act as an independent contractor pursuant to this Agreement...[and]...This Agreement, including all exhibits, constitutes the entire agreement

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[2]The court takes judicial notice of the commonly known industry fact that a placement agent is a registered broker-dealer who is hired by an issuer of securities to find institutional investors willing to invest in the securities being offered by the issuer.

among the parties with respect to the subject matter hereof."

In their NASD Dispute Resolution Statement of Claim, respondents allege the following. In or about November 2004, respondents purchased $50 million worth of Strategy units from SREI. Prior to this purchase, McMahon, acting as Strategy's placement agent, presented a Confidential Private Placement Memorandum (PPM) and power point presentation (the Presentation) to respondents outlining the details of the Offering. During the PPM and Presentation, McMahon stated that the sought-after $50 million would be invested, via short-term mortgages, in Canadian residential real estate being developed by Lux Group, Inc. (Lux), a company under common control with SREI. Three individuals, John Hamilton, Sandro Sordi and Kevin Hamilton were described as the management team in charge of investing the funds. Background information regarding their previous financial and business experience was provided. However, McMahon failed to disclose that all three men either had prior criminal convictions or other legal problems throughout their careers.

Specifically, in 1995, Sordi and John Hamilton were involved in writing false and post-dated checks to their employees arising out of a failed donut shop. Also in 1995, Sordi pled guilty in a Canadian court to criminal charges associated from willfully furnishing false information and misappropriating government funds. In 2002, Sordi was found guilty in Broward County, Florida of fraud and theft arising from two separate actions. John Hamilton was involved in the transactions surrounding each suit but was not found liable for any wrongdoing. Kevin Hamilton pled guilty in 2001 to Canadian charges of falsifying tax returns and was ordered to pay $5 million (Canadian) in back taxes and fines. In addition, Kevin Hamilton twice filed for bankruptcy, in 1996 and 2003.

As part of the PPM, McMahon also showed each investor a copy of the Subscription Agreement they would be required to enter into with Strategy in order to effectuate the transaction. The Subscription Agreement referred to, *inter alia*, Strategy's financial condition and verified the accuracy of its SEC filings. According to the terms of the Subscription Agreement, all of Strategy's SEC reports were in full compliance with the Securities Act of 1933, and contained no untrue statements or omissions of any material facts. The Subscription Agreement further stated that Strategy's financial reports were prepared in accordance with generally accepted accounting principals (GAAP) and accurately depicted the financial condition of Strategy and all its subsidiaries. In addition, Strategy warranted that no major occurrences or developments had transpired since its last audit which materially affected the company's financial state. At the time the Subscription Agreement was executed, Strategy represented that it had assets of mortgage notes receivable totaling $104,231,610, which were secured by mortgages on Canadian real estate. The Subscription Agreement also called for SIIG to register the securities that were to be held as convertible by the warrants, or be liable for liquidated damages.

The Subscription Agreement contained the following clauses:

> 13. Binding Effect; Beneficiaries. This Subscription Agreement and the representations and warranties contained herein shall be binding upon, inure to the benefit of and be enforceable by the parties hereto and their respective heirs, assigns, executors, administrators and other successors, and *no other persons or entities* (emphasis added).
>
> 14. Governing law; Submission to Jurisdiction; Waiver of Trial by Jury.
> (b) Any controversy, claim or dispute arising out of or relating to this Subscription Agreement between the parties hereto, their assignees, their affiliates, their attorneys, or agents, shall be litigated solely in state or federal court in New York City.
>
> 15. Remedies. The parties hereto agree that in the event of any dispute between the

> parties hereto arising out of, relating to or in connection with the Company or this Subscription Agreement or the Subscriber's investment in the Company, such dispute shall be resolved exclusively by arbitration to be conducted in New York, New York, in accordance with the rules of the American Arbitration Association.

Each respondent executed a Subscription Agreement with Strategy on or about November 16, 2004. McMahon was not a signatory or party to any Subscription Agreement.

On or about September 16, 2005, Strategy filed a Form 10-KSB with the SEC for its annual fiscal period ending April 30, 2005 (the April Report). The April Report disclosed that on or about August 12, 2005, Strategy discovered the mortgages underlying its notes receivable had been discharged in October 2004 by the beneficial owners of the Series A and B Preferred shares, as well as other corporate entities they controlled. As a result, since the mortgages had been discharged, the underlying notes were unsecured. Therefore, according to GAAP, the notes should have been recorded as contra-equity, rather than assets, on Strategy's financial statements. Strategy noted this change in the April Report. Since the mortgages were discharged in October 2004, prior to the date of the Offering and respondents' purchase of the units, the investors allege that representations made by McMahon in the PPM and Presentation regarding Strategy's financial status were false and misleading.

On February 7, 2006, respondents filed an action against Strategy, Sordi, John Hamilton, and others in United States District Court for the Southern District of New York, alleging breach of contract, fraud, violation of SEC Rule 10b-5 and the Blue Sky laws of Minnesota, California and Texas. Around this time, SREI also provided respondents with two letters from RBC Dominican Securities Inc. (RBC). These letters stated that approximately $32 million of respondents' investment was being held in an SREI account at RBC. In or about July 2006,

respondents moved to have these accounts frozen. During oral argument on this motion, SREI stated that the funds were no longer being held at RBC. Respondents never discovered where the funds were moved. The Federal action settled in or around May 2007.

Respondents filed their NASD Statement of Claim against petitioner in July 2007, alleging fraud, negligent misrepresentation, negligence and violation of the Blue Sky laws of California, Connecticut and Minnesota. Since no written agreement to arbitrate exists between the parties, respondents sought arbitration under the NASD Code of Arbitration Procedure Rule 12200 (Rule 12200), which would compel McMahon to arbitrate, as a result of its NASD membership, upon the request of a customer. McMahon subsequently filed the instant petition seeking to stay the NASD arbitration arguing, *inter alia*, that respondents were not its customers in relation to the Offering.

*II. Conclusions of Law*

The Federal Arbitration Act (FAA) provides that an arbitration provision in "a contract evidencing a transaction involving commerce...shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or equity for the revocation of any contact." *Diamond Water Proofing Sys. Inc. v. 55 Liberty Owners Corp.*, 4 N.Y.3d 247, 252 (2005), quoting 9 U.S.C. § 2. "Involving Commerce" is the functional equivalent of the phrase "affecting commerce" signaling congressional intent to exercise its full commerce clause powers. *Id.*, citing *Allied-Bruce Terminix Cos., Inc. v. Dobson*, 513 U.S. 265, 273-274 (1995). As a result, where an arbitration provision "affects" interstate commerce, disputes arising therefrom are subject to the FAA. *Id.*

Petitioner, a Delaware corporation with its principal place of business in Greenwich, Connecticut, acted as Strategy's Placement Agent during the Offering. SIIG, a Texas corporation

with its principal place of business in Ontario, Canada sold units of preferred stock to respondents, international and domestic business entities located in California, Connecticut and Minnesota. Therefore, the transactions here clearly affect interstate commerce, and are thus subject to the FAA.

"Arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." *John Hancock Life Ins. Co., Inc. v. Wilson*, 254 F.3d 48, 58 (2d Cir 2001), quoting *AT&T Techs., Inc. v. Communications Workers of Am.*, 475 U.S. 643, 648-49 (1986). In deciding questions of arbitrability, the court must determine whether an agreement to arbitrate exists and if the dispute falls within the scope of such agreement. *Spear, Leeds & Kellogg v. Central Life Assurance Co.*, 85 F.3d 21, 25 (2d Cir 1996).

*A. Valid Agreement to Arbitrate*

The 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. *Vestax Securities Corp. v. McWood*, 280 F.3d 1078, 1081 (6th Cir 2002) ("The NASD Code of Arbitration Procedure...creates the right of parties to compel an NASD-member firm to arbitrate even in the absence of a direct transactional relationship with the firm."); *King*, 386 F.3d at 1367 ("the Code serves as a sufficient written agreement to arbitrate, binding its members to arbitrate a variety of claims with third-party claimants."). Even where two parties have not entered into a direct agreement to arbitrate, NASD Rules 10101 and 10301(a) [now codified as Rule 12200] can bind an NASD member to arbitrate certain third-party claims. *O.N. Equity Sales Co. v Staudt*, 2008 U.S. Dist. Lexis 7777, *8 (D Vt 2008).

Although the arbitration provision is governed by the FAA, the court must interpret the

NASD Code according to New York contract principles to determine if the parties agreed to arbitrate. *King*, 386 F.3d at 1367, citing *Chelsea Square Textiles v. Bombay Dyeing & Mfg. Co.*, 189 F.3d 289, 296 (2d Cir 1999) ("in determining whether parties agreed to arbitrate [we] look[] to general state law contract principles for guidance"). As in any other contract, the court must give full effect to the parties' intent expressed by the ordinary language of the provision. *John Hancock*, 254 F.3d at 58, citing *PaineWebber v. Bybyk*, 81 F.3d 1193, 1199 (2d Cir 1986); *Am. Express Bank Ltd. v. Uniroyal*, 164 A.D.2d 275, 277 (1st Dept 1990). However, unlike other contracts, "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *John Hancock*, 254 F.3d at 58, quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1986).

McMahon does not contest that its NASD membership creates an agreement to arbitrate all disputes contemplated under Rule 12200. Therefore, the first prong of the analysis has been satisfied, and the court will assess whether the relationship between McMahon and the respondents falls within the scope of NASD rules.

*B. NASD Code of Arbitration Rule 12200*

NASD Code of Arbitration Rule 12200 provides:

> Parties must arbitrate a dispute if:
>
> Arbitration under the Code is either:
> (1) Required by a written agreement, or
> (2) Requested by the customer;
> The dispute is between a customer and a member or associated person of a member; and
> The dispute arises in connection with the business activities of the member or associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

To compel an NASD member to arbitrate under this provision, courts require that an investor's

claim: involve a dispute between a member and a customer or an associated person of the member and a customer; and arise in connection with the business activities of the member or in connection with the business activities of the associated person. *John Hancock*, 254 F.3d at 58; *King*, 386 F.3d at 1367; *Vestax*, 280 F.3d at 1081.

*1. Respondents are McMahon's Customers Pursuant to Rule 12200*

McMahon argues that none of the respondents were its customers in relation to the Offering. According to McMahon, the court should use the definition of customer embodied in NASD Rules of Conduct § 2270 entitled "Disclosure of Financial Condition to Customers." Rule 2270 defines customer as "any person, who, in the regular course of such member's business, has cash or securities in the possession of such member." Consequently, McMahon argues respondents were never its customers since they never delivered any cash or securities to it during the Offering.

NASD's definition of customer, however, is broad, excluding only a broker-dealer, and clearly includes customers of any person associated with the member. *Financial Network Investment Corp. v. Becker*, 305 A.D.2d 187, 188 (1st Dept 2003), citing *John Hancock*, 254 F.3d at 59. "When the investor [customer] deals with an agent or representative [of a member], the investor deals with the member, and on that basis the investor is entitled to have resolved in arbitration any dispute that arises out of that relationship." *Becker*, 305 A.D.2d at 188, quoting *Vestax*, 280 F.3d at 1082.

The argument proffered by McMahon, which attempts to narrow the definition of customer, has previously been rejected. For example, in *Multi-Financial Securities, Corp. v. King*, 386 F.3d 1364 (11th Cir 2004), NASD member IFG argued that since no direct transactional relationship existed between it and King, an investor, King was not its customer.

The court rejected IFG's argument, citing to *Becker*, *id.*:

> Enforcing the limitation IFG seeks would be tantamount to reading language into the Code that is conspicuously absent. Other inapplicable NASD rules [such as Rule 2270 regarding the disclosure of financial condition to customers and Rule 2520 regarding margin requirements] do make a distinction between customers generally and customers of a member....Rules 2270(b) and 2520(a)(3) show that the NASD could limit the term 'customer' specifically to those with whom the member has a direct transactional relationship. Its clear and unambiguous choice to leave the term as defined generally immediately leads to the conclusion that King satisfies the 'customer' requirement because she is not a broker or a dealer, even though she may not have been a direct customer of IFG.

*King*, 386 F.3d at 1368.

The broad definition of customer articulated in *John Hancock*, 254 F.3d at 59, and adopted by the First Department in *Becker,* 305 A.D.2d at 188, represents the majority view. As noted in *John Hancock*: "There is nothing in the language of Rule 10301, or any other provision of the NASD Code, that compels us (or even suggests that we ought) to adopt John Hancock's narrow definition of the term 'customer.' In fact, the NASD Code defines customer broadly, excluding only 'a broker dealer.' Rule 0120(g). The Investors are neither." *Id.* at 59. *Accord Washington Square Sec., Inc. v. Aune*, 253 F Supp 2d 839, 841 n.1 (WD NC 2003) ("The majority view [on Rule 10301] is stated in the *John Hancock* opinion"); *Daugherty v. Washington Square Sec., Inc.*, 271 F Supp 2d 681 (WD PA 2003) ("The majority of federal courts faced with interpreting NASD Rule 10301(a) concluded NASD members must arbitrate disputes raised by customers of their associated persons"); *Vestax*, 280 F.3d at 1082 (adopting *John Hancock's* view rejecting argument that Rule 10301 requires defendant-investors be direct customers of NASD-member firm in order to compel arbitration against member); *Washington Square Secs. Inc. v. Sowers*, 218 F. Supp. 2d 1108, 1116 (D Minn 2002) ("Federal case law plainly states that when the investor deals with an agent or representative [of an NASD member], the investor deals with the member, and on that basis the investor is entitled to have resolved in

arbitration any dispute that arises out of that relationship").

Here, respondents dealt with McMahon, Strategy's Placement Agent, during the Offering. Respondents are not broker-dealers. Institutional investors, who enter into subscription agreements with third-party representatives of an NASD member, qualify as the member-firm's customers in a private placement transaction compelling arbitration pursuant to Rule 12200. *The O.N. Equity Sales Co. v. Staudt*, 2008 U.S. Dist Lexis 7777 (D Vt Jan. 30, 2008); *The O.N. Equity Sales Co. v. Hoegler*, 2008 U.S. Dist. Lexis 5852 (D NJ Jan. 28, 2008); *The O.N. Equity Sales Co. v. Thiers*, 2008 U.S. Dist. Lexis 3765 (D Ariz Jan. 10, 2008); *The O.N. Equity Sales Co. v. Pals*. 509 F. Supp. 2d 761 (ND Iowa 2007); *The O.N. Equity Sales Co. v. Venrick*, 508 F. Supp. 2d 872 (WD Wash 2007); *The O.N. Equity Sales Co. v. Steinke*, 504 F. Supp. 2d 913 (CD Cal 2007); *The O.N. Equity Sales Co. v. Wallace*, 2007 U.S. Dist. Lexis 84945 (SD Cal Nov. 15, 2007); *The O.N. Equity Sales Co. v. Rahner*, 2007 U.S. Dist. Lexis 90917 (D Colo Nov. 30, 2007); *The O.N. Equity Sales Co. v. Gibson*, 514 F. Supp. 2d 857 (SD W Va 2007); *The O.N. Equity Sales Co. v. Samuels*, 2007 U.S. Dist. Lexis 90332 (MD Fla Nov. 30, 2007). Respondents, thus, were McMahon's customers pursuant to NASD Rule 12200.

*2. The Dispute Arises in Connection With McMahon's Business Activities*

The NASD requires that its members supervise the activities of its associated persons. *Staudt*, 2008 U.S. Dist. Lexis at *13, citing *King*, 386 F.3d at 1370; *John Hancock*, 254 F.3d at 58-59. Therefore, any dispute arising from a firm's lack of supervision over its brokers arises in connection with its business activities. *Id.*; *Vestax*, 280 F.3d at 1082. Here, the essence of respondents' negligence claim is that McMahon failed to supervise the activities of its own representatives in connection with the fraud and misrepresentations they perpetrated on the investors before, during, and after the Offering. Consequently, the court finds that Rule 12200's

second condition is satisfied and petitioner is bound to arbitrate pursuant to the NASD rules. *Id.*; *see also Becker*, 305 A.D.2d at 188 ("It suffices that there was a business relationship with the representative that related directly to its investment services.")

*C. Forum Selection Clause*

Finally, petitioner argues that even though it is not a party to the Subscription Agreement, it can invoke the forum selection clause contained in paragraph 14 and, thereby, avoid arbitration. The court believes that petitioner must submit to arbitration pursuant to the NASD rules. Nonetheless, it will address this argument.

McMahon contends that it is closely related to Strategy since it acted as Strategy's Placement Agent and, therefore, it may invoke the agreement's forum selection clause. *See Freeford Limited v. Pendelton*, 2008 NY Slip Op 3148 (1st Dept 2008) (non-signatory may invoke contract's forum selection clause when non-signatory is third-party beneficiary, non-signatory is party to global transaction or non-signatory is closely related to party to contract and its enforcement of clause is foreseeable.) This argument, however, ignores paragraph 13 of the contract, which explicitly excludes all but the signatories and their successors from the contract's provisions. The clear and unambiguous language of the contract, thus, excludes McMahon from paragraph 14. *See Lopez v. Fernandito's Antique*, 305 A.D.2d 218, 219 (1st Dept 2003) (contracts must be interpreted according to their plain meaning). Accordingly, it is

ORDERED that the petition to [redacted] arbitration is denied and the proceeding is dismissed.



ENTER

DATE: May 13, 2008
New York, NY

*J.S.C.*