

IN THE UNITED STATES DISTRICT COURT  
FOR THE SOUTHERN DISTRICT OF TEXAS  
HOUSTON DIVISION

INSTITUTIONAL CAPITAL §  
MANAGEMENT, INC. AND §  
DANIEL L. RITZ, JR. §  
V. §  
LEONARD CLAUS, IMS SECURITIES, §  
INC., STERLING FINANCIAL §  
INVESTMENT GROUP, INC., ROBERT §  
L. HARVEY AND GERARD JOSEPH §  
PEPE §

CIVIL ACTION NO. \_\_\_\_\_

**Complaint and Motion to Vacate Arbitration Award of  
Institutional Capital Management, Inc. and Daniel L. Ritz, Jr.**

1. Institutional Capital Management, Inc. and Daniel L. Ritz, Jr. allege and move the Court as follows:

**1.  
Jurisdiction and Venue**

2. The Court has jurisdiction over this motion to vacate an arbitration award under, among other statutes, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, because the claimants in the underlying arbitration alleged violations of same,<sup>1</sup> *see* App. Tab 2 (Second Amended Statement of Claim), and under the Federal Arbitration Act, 9 U.S.C. § 10(a)(4), because the arbitration raised questions of Federal law. Venue is appropriate in the Southern District of Texas, Houston Division, because the arbitration was heard in Houston, Texas.

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<sup>1</sup> References to supporting documents in the accompanying appendix are marked “App. Tab \_\_\_\_.” References to exhibits entered into evidence in the arbitration hearing will also contain the abbreviation “Exh.”.

**2.**

**Nature of the Action**

3. Institutional Capital Management, Inc. (“ICM”) moves vacate an arbitration award rendered on May 21, 2007, by a panel of arbitrators appointed by the National Association of Securities Dealers (“NASD”). App. Tab 2 (award). Claimant Leonard Claus alleged that respondents had agreed to buy bonds from him, refused to take delivery of them, and thereby caused Claus to suffer about \$230,000 in market losses and other consequential damages. Respondents alleged that Claus was able to sell the bonds without suffering a dime in out-of-pocket losses but had concealed that fact from the arbitration panel until confronted with claimant’s own documents showing that sale. Respondents also alleged they never had any duty to take delivery of claimant’s bonds.

4. The panel awarded \$25,000 to claimant Leonard Claus and \$70,000 in attorney’s fees, to be paid by respondents directly to Claus’s attorney, not Claus himself. Because the award assesses nearly \$22,000 in NASD forum fees and costs against Claus, the award leaves essentially nothing to him. The panel had no authority under any contract, agreement, or governing law to “pour out” the claimant and then direct respondents to pay Claus’s attorney – not Claus himself – \$70,000 in attorney’s fees. This Court must therefore vacate the panel’s order.

**3.**

**Standard of Review**

5. On a motion to vacate an arbitration award, appellate courts review a district court's findings of fact for clear error and questions of law *de novo*. *Prescott v. Northlake Christian School*, 369 F.3d 491, 494 (5<sup>th</sup> Cir. 2004).

**4.  
The Parties**

6. ICM is a broker-dealer licensed under the Federal securities laws. ICM's principal place of business is in Houston, Texas. ICM can be served through its attorneys.

7. Daniel L. Ritz, Jr., President of ICM, is a resident of Houston, Texas. Mr. Ritz can be served through his attorneys.

8. Sterling Financial Investment Group, Inc. is a broker-dealer licensed under the Federal securities laws. Sterling's principal place of business is Boca Raton, Florida.

9. Robert L. Harvey, formerly of Sterling, resides in Boca Raton, Florida.

10. Gerald Joseph Pepe, formerly of Sterling, resides in Boca Raton, Florida.

11. Leonard Claus of IMS Securities resides in Houston, Texas and may be served with process at IMS Securities, Inc., 1500 City West Blvd., Houston, Texas 77042.

12. IMS Securities, Inc. is a broker-dealer licensed under the Federal securities laws. IMS's principal place of business is in Houston, Texas, and it may served through its President, Jackie Wadsworth, at 1500 City West Blvd., Houston, Texas 77042.

**5.  
Background Facts and Proceeding**

***A. Reservation of Right to Supplement Motion***

13. Because this case arises from an arbitration under the auspices of the NASD, there is no transcribed testimony, but only copies of 29 cassette tapes recorded on a single-track and single-microphone tape recorder received just days ago by counsel for ICM. ICM has initiated transcription of what it believes to be the pertinent portions of the proceedings and will supplement the record accordingly.

***B. Orientation: Small Broker-Dealers and “Riskless Principal” Trading***

14. This case arises out of an arbitration involving three small broker-dealers: IMS (Claus’s firm), ICM (Ritz’s firm), and Sterling. As bond traders, they make money on “spreads” – that is, markups charged to buyers and markdowns charged to sellers. As a rule, they hold no inventory. App. Tab 3 (IMS Manual, at 13, in NASD record as ICM Exh. 17) (“The Firm cannot, under any circumstances, hold funds or securities for...customers.”). Any time they execute a “sell” trade they must “buy” a matching trade on the same day at the same time. *Id.* at 22. (“The Firm will undertake principal transactions...for fixed income securities, where the income security is purchased and sold in the same trading day.”). These broker-dealers must avoid any “long” or “short” positions. *See id.*

15. For example, if a broker-dealer buys securities but fails to sell them that day, the broker-dealer has an “inventory” of a volatile asset – a publicly traded security. *See id.* Under Federal law, the broker-dealer must report that position to the NASD and take a “haircut” on its net capital. *Id.* at 18 (“The Firm has the responsibility of being able to demonstrate that it is in compliance with the Minimum Net Capital Rule 24 hours a day...Investments for the Firm’s trading accounts receive haircuts...”). Holding a position rather than selling it could require the broker-dealer to shut its doors.

16. Nevertheless, small broker-dealers often trade positions that have risk well in excess of their relatively small net capital. This case shows what can happen when a broker engages in such trading but fails to match a large buy order with a sell order in the same trading day.

***C. Claus Buys Bonds But Fails to Sell***

17. The undisputed testimony at the hearing – much of which the Panel heard in the form of recorded phone conversations – showed the following:

18. On January 28, 2005, Claus, Short, and brokers from Sterling discussed potential trades. One trade would involve over \$2 million in Freddie Mac bonds (collateralized-mortgage obligations or CMOs). These Freddie Macs are a particularly volatile type of CMO known as “inverse floaters.” A small rise in interest rates will cause the price of inverse floaters to plummet. Claus initially wanted to sell the bonds to Short, but then Short asked Claus to sell them to another broker-dealer firm, Sterling Financial.

19. Claus called Sterling. Sterling’s reps said that before Sterling did the trade it had to get Claus/IMS “preapproved” for trading with Sterling’s clearing firm. (Each of the broker-dealers in this case rely on clearing firms to ensure that trades are settled appropriately and to maintain the paperwork associated with the clearing and executing of trades.)

20. Claus did not wait for preapproval. He testified that he assumed Sterling’s clearing broker would “preapprove” IMS and Claus. (Sterling and ICM presented evidence that industry rules and practices require preapproval and forbid assumptions like this.) At about 11:46 a.m. CST, Claus bought \$2,276,505 in bonds from another broker-dealer, Jencks & Co. App. Tab 4 (ICM Exh. 3(4), at CL 498, CL 106). He paid 89½ for bonds with a par value of \$3.2 million. Claus drafted a sell order to Sterling at 90 1/8, which would yield a “spread” to IMS of \$15,838, *see* App. Tab 4 (ICM Exh. 3(1)), at CL 104, of which Claus testified he would keep roughly \$14,000.

21. After a couple of hours, Sterling decided not to do the trade based on concerns about the pricing that Short and Claus had structured. Claus protested to Sterling but Sterling refused to do the trade. That same afternoon, Claus called Short to complain about Sterling. Short said that he did not think Claus had bought the bonds; he did not think the trade had gone through yet. Short told Claus that “it’s not their responsibility, it’s mine” and told Claus that if Claus lost money in selling the bonds back, Short would “stand good for the bonds” that Claus

had bought. Jerry Short urged Claus to sell the bonds back to the dealer from whom he had bought them to cover any loss. Short asked Claus to let him know. (Jerry Short died in August 2005 and never provided any witness statements or testimony in connection with this matter.)

22. Claus chose not to sell that afternoon. Claus testified that he had asked Jencks & Co. to undo his buy order of \$2,276,505. But, according to Claus, Jencks & Co. told Claus that he would have to take a \$500,000 or \$600,000 loss to do so. (Claus never wrote this down in his notes or in any memos, nor did he ever advise Short or ICM about it. Respondents testified and provided market data evidence that they concluded Claus could have – and should have – unwound the sale that day with no cost.) In any event, basic math tells us that an unwinding of the trade at any price less than 90 1/8 would cut into IMS's spread of \$15,838. Similarly, an unwinding at 89½ would mean no spread at all but would have avoided any out-of-pocket loss.

23. For several days after the failed trade, Claus sent faxes and emails to Sterling, asking them to take delivery of the bonds of 90 1/8. Sterling refused. Claus made no demands on ICM during this time.

24. By February 3, 2005, Claus's clearing firm told him that Claus could no longer hold the bonds. Claus relented. He sold the bonds to another broker-dealer for 89½ -- exactly the price he paid for them (with a nominal adjustment for accrued interest). In other words, Claus got out of the trade without suffering any out-of-pocket losses (but he also lost the chance to make the \$15,838 "spread" he had to generate if Sterling had bought the bonds at 90 1/8).

25. One would think that was the end of the matter. But it wasn't. Later that month, interest rates went up, causing CMO prices to tumble. *See, e.g.*, App. Tab 5 (ICM Exh. 6). Claus came to ICM's president, Ritz, and demanded that ICM pay the full 90 1/8. (Claus did not mention that he had sold the bonds on February 3 at 89½, the price Claus paid for them, thereby

avoiding any out-of-pocket losses.) At this point, the CMOs traded in the 85 range, well below the 89½ that Claus had bought (and, secretly at this point, sold) them at.

26. ICM took the same position as Sterling: Claus should never have bought the bonds until the deal was final, and he was not entitled to any damages because he should have sold them back right away instead of holding them (something he was not supposed to do anyway, per the net-capital rules above).

27. In April 2005, Claus initiated this arbitration. He sued ICM, Sterling, and various individuals in the firms. In the final hearing, Claus claimed damages in excess of \$400,000. This claim consisted of:

- \$146,000 in alleged market losses (again, based on prices in late February 2005, not the February 3 sale at 89½);

- \$62,829 in “additional” (mostly consequential) damages;

- \$31,272 in prejudgment interest; and

- \$170,000+ in attorney’s fees (based on counsel’s hourly billing rates of roughly \$275 per hour, but acknowledging that Claus’s counsel took the case on a 40% contingency-fee arrangement)

*See, e.g.*, App. Tab 6 (Claus Exh. 88A).

28. Claus’s damages model says nothing about the February 3 sale at 89½. *See* Claus Exh. 88A. In fact, respondents discovered it late in the case buried in “trade runs” that Claus produced in response to a panel discovery order. App. Tab 7 (Claus Exh. 89). The February 3, 2005 sale at 89½ – which protected Claus from any losses – appears on line 6 of App. Tab 7.

29. In direct examination, Claus continued to conceal the February 3, 2005 sale. In fact, Claus testified that throughout February 2005 he conducted an “aggressive marketing campaign” to find a buyer for the bonds but could find one only after interest rates had increased (and CMO prices correspondingly plummeted).

30. Only during cross-examination, confronted with the February 3 sale at 89½, buried deep in Claus’s own records, did Claus acknowledge making that sale. This gave lie to Claus’s earlier testimony about the so-called “aggressive marketing campaign” and destroyed his six-digit damages claim.

31. The Panel awarded Claus the following relief:

	ICM	Sterling
Award to Claus	\$20,000	\$ 5,000
Attorney’s fees -- to Claus’s lawyer	40,000	30,000
Total	\$60,000	\$35,000

App. Tab 2, at 4-5.

32. The Panel also assessed NASD fees against Claus and IMS of \$21,275. *Id.* at 7-9. The Panel assessed forum fees and member fees of \$12,650 against ICM and \$13,750 against Sterling. *Id.* NASD fees are not in dispute here.

33. In short, the panel awarded Claus essentially nothing but made a separate, independent fee award directly to Claus’s lawyer. The panel had no authority to make this direct attorney’s fee award.

## 6.

### **Argument and Authorities**

#### ***The Panel Had No Authority to Assess an Award Against ICM Payable Directly to Claus’s Lawyer***

34. The Panel exceeded its authority in awarding \$70,000 in attorney’s fees (\$40,000 against ICM) to Claus’s lawyer directly. Any fee award must be made to Claus directly; the panel had no authority to make it. This Court must therefore vacate the entire award and remand the case to the NASD for further proceedings.

35. Under the Federal Arbitration Act, 9 U.S.C. § 10(d), this court “may make an order vacating the award upon the application of any party to the arbitration –

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.”

36. The parties’ agreements and/or submissions define the arbitrators’ jurisdiction for purposes of determining whether the arbitrators exceeded their authority under § 10 of the FAA. *See, e.g., Kergosien v. Ocean Energy, Inc.*, 390 F.3d 346, 345-55 (5<sup>th</sup> Cir. 2004). The Fifth Circuit consistently vacates orders in which arbitrators render awards that exceed their authority. *See Apache Bonhai Corp. v. Texaco China BV*, 480 F.3d 397, 401 (5<sup>th</sup> Cir. 2007) (“If the contract creates a plain limitation on the authority of an arbitrator, ***we will vacate an award that ignores the limitation.***”)

37. Here, the NASD’s rules (and the parties’ submissions consenting to those rules) limited the arbitrators’ authority to award attorney’s fees under “applicable law.” In awarding attorney’s fees to a non-party contrary to applicable law, the panel exceeded their powers. Here, the parties’ Uniform Submission Agreements – supplied by the NASD – provide:

The undersigned parties hereby submit the present matter in controversy...to arbitration in accordance with the Constitution, By-Laws, Rules, Regulations, and/or Code of Arbitration Procedure of the sponsoring organization.

Uniform Submission Agreements of ICM, Ritz, IMS, and Claus, attached hereto at App. Tabs 8-10. In other words, under the submission agreements, the NASD’s rules govern. Rule 10215 of the Code of Arbitration Procedure specifically addressed attorney’s fees:

The arbitrator(s) shall have the authority to provide for reasonable attorney’s fees reimbursement, in whole or in part, as part of the remedy ***in accordance with applicable law.***

App. Tab 11.

38. In other words, “applicable law” governed the panel in its rendering of the award. In this case, “applicable law” is clear: the arbitrators had no power to enter an award against ICM in favor of a nonparty, Claus’s lawyer.

39. As the Supreme Court has held, “it is the *party’s* entitlement to receive the fees in the appropriate case” – not the lawyer’s. *Venegas v. Mitchell*, 495 U.S. 82, 83 (1990) (emphasis added). *Venegas* involved a civil-rights claim in which plaintiff Venegas obtained a \$2 million judgment. The Court awarded one of plaintiff’s attorneys, Mitchell, \$75,000. But attorney Mitchell had a 40% contingency fee interest in the case. Venegas refused to pay the 40% share, so Mitchell filed a lien on the judgment.

40. The Supreme Court ruled for attorney Mitchell on the ground that a Court cannot override a contingency-fee agreement by making a separate attorneys’ fee award to a party. *Venegas*, 495 U.S. at 90. Central to the Court’s holding was the rule from cases like *Evans v. Jeff D.*, 475 U.S. 717, 731-32 (1986), that attorney’s fees awards belong to the party, not the lawyer. In so ruling, the Court reaffirmed this principle, long held in the circuit courts of appeals and district courts. See generally *White v. New Hampshire*, 659 F.2d 697, 703 (1<sup>st</sup> Cir. 1980), *rev’d on other grounds*, 455 U.S.445 (1982); *Brown v. GM*, 722 F.2d 1009, 1011 (2d Cir. 1983) (“It is the prevailing party rather than the lawyer who is entitled to attorney’s fees); *Rhoads v. FDIC*, 286 F. Supp. 2d 532, 542 (D. Md. 2003) (noting that “any entitlement to attorney’s fees belongs to [the party] alone”).

41. The panel award against ICM (and Sterling) presents a crystal-clear violation of the rule of *Venegas* and *Evans v. Jeff D.*: an arbitration panel cannot override a contingency-fee agreement by making an award directly to the claimant’s lawyer. In fact, the panel’s award here involves a more serious violation of the rule of *Venegas* and *Evans v. Jeff D.* than did the district court’s ruling in *Venegas*. In *Venegas*, the district court committed reversible error when it overrode a contingency-fee agreement to benefit a *party*. Here, by contrast, the panel exceeded its authority when it overrode a contingency-fee agreement to benefit a *lawyer*. To do so, the panel awarded substantial relief to Claus’s lawyer -- someone outside the scope of the arbitration

agreement and who never made an appearance as a claimant -- while awarding Claus himself essentially nothing.

42. The NASD rules further underscore the panel's overreaching of its authority. Under the NASD's rules, the arbitrators had "the authority to provide for reasonable attorneys' fee reimbursement, in whole or in part, as part of the remedy *in accordance with applicable law*." NASD Rule 10215 (App. Tab 11) (emphasis added). In awarding fees directly to Claus's lawyer, this Panel exceeded its authority under the Federal Arbitration Act and the NASD's rules. The applicable law of attorney's fees, from the Supreme Court down, could not be clearer.

43. Here, the only statutory bases of attorney's fees in Claus's claim were under § 38.001 of the Tex. Civ. Prac. & Rem. Code and the Texas Securities Act. As with § 1988 in *Venegas*, neither of these state statutes provide for awards to be payable directly to attorneys. See, e.g., *Murrco Agency, Inc. v. Ryna*, 800 S.W.2d 600, 603 (Tex. App. – 1990, no writ). As the *Murrco Agency* court observed, the Texas Legislature has had no difficulty in specifically providing that attorney's fees may be awarded to the attorney. *Id.* at 603 n.l. (citing Tex. Fam. Code §§ 3.77, 3.93). An earlier decision, *Streeter v. Thompson*, 751 S.W.2d 329, 331 (Tex. App. – Fort Worth 1988, no writ), fits the facts here:

[W]e note that the parties in their pleadings have prayed for the recovery of attorney's fees to their respective attorneys. [Moreover,] since the attorneys were not parties they were not before the court and are not entitled to any relief.

44. Claus may cite cases such as *Newman v. Link*, 889 S.W.2d 288, 289 (Tex. 1994), for the proposition that a judgment that includes attorney's fees may make the attorney a party to the judgment (which facilitates enforcement of claims for attorney's fees, as happened in *Venegas*). But *Newman* involved an *ad litem* fee award to which the complaining lawyer failed to object before entry of judgment. The complaining lawyer waited a full year after judgment

and then challenged the *ad litem* award in a collateral injunction proceeding. Here, no judgment has been entered and the complaining party has filed a timely challenge.<sup>2</sup>

45. If anything, the panel's direct fee award to Claus's lawyer flies in the face of the long-standing principle of freedom of contract. In case after case, the Texas Supreme Court has reiterated that "[w]e have long recognized a strong public policy in favor of preserving the freedom of contract." *Lawrence v. CDB Servs., Inc.*, 44 S.W.2d 544, 533 (Tex. 2001). Just weeks ago, the Texas Supreme Court reaffirmed this policy, stating that:

[P]ublic policy requires . . . that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice. Therefore, you have this paramount public policy to consider -- that you are not lightly to interfere with this freedom of contract.

*Gym-N-I Playgrounds, Inc. v. Snider*, 2007 Tex. LEXIS 325; 50 Tex. Sup. J. 634 (April 20, 2007), quoting *Wood Motor Co. v. Nebel*, 150 Tex. 86, 238 S.W.2d 181, 185 (1951).

46. In this case, the panel's award would rewrite the contingency-fee contract between Claus and his lawyer in abrogation of Texas's strong policy favoring enforcement of valid contracts. This strong public policy dovetails with the U.S. Supreme Court's decision in

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<sup>2</sup> See also *Hadnot v. Wenco Distributors*, 961 S.W.2d 232, 236-37 (Tex. App. – Houston [1<sup>st</sup> Dist. 1997, pet denied) (following *Newman v. Link*). *Hadnot* involved a claim for attorney's fees under the lien provisions of the Texas Property Code. The *Hadnot* court based its decision on its failure to see any reason "why an award of attorney's fees directly to [the plaintiff's lawyer] would frustrate the intent of the chapter 53 [of the Texas Property Code.]" Here, unlike *Hadnot*, the attorney's fee award would frustrate the intent of § 38.001 and the TSA in rewarding attorneys for filing marginal cases. Moreover, unlike *Hadnot*, the fee award here would impose a **significant harm** on ICM, particularly in light of the panel's nominal award to the underlying plaintiff.

In lien cases such as *Hadnot*, the attorneys' fee award becomes a separate property interest, enforceable *in rem* as well as *in personam*. The harm visited on a lien debtor is light years from the kind of attorneys' fee award in a complex and contested arbitration that has involved two years of litigation and an eight-day final hearing.

*Venegas*. See *Venegas*, 495 U.S. at 90 (“Section 1988 itself does not interfere with the enforceability of a contingent-fee contract.”).

47. Moreover, nothing this Court does, short of vacatur, will cure the fatal defects in this award. For example, the Court cannot, consistent with the FAA, modify the award or refuse to vacate it. Two related reasons compel this conclusion. First, the award presents a conflict of interest for Claus and his lawyer. Claus presumably has some incentive to move to vacate the award too; he would rather get the attorneys’ fee award (sharing 60% with his lawyer), rather than let his lawyer get the whole \$70,000. By contrast, Claus’s lawyer presumably has no incentive for Claus to get a piece of it; he would rather take the money and let Claus keep whatever crumbs are left, if any, of his \$25,000 award after NASD fees and arbitration expenses. This conflict presents a fatal defect to the integrity of the award and any judgment this Court might make to enforce it.

48. Second, this Court cannot merely fix the problem by merely modifying the award to go to Claus instead of his lawyer. Section 11(b) and 11(c) of the FAA forbid modification “affecting the merits” of the decision upon the matters submitted or the controversy itself. Here, Claus’s lack of credibility shines through both the record in this case as well as the panel’s award. A modification of the award would fundamentally alter the panel’s assessment of the merits. Although the Panel gives no reasoning, it is safe to say that the panel’s stinginess toward Claus coupled with its generosity toward his lawyer reflects *something* about the merits. Nothing short of vacatur will cure the defects in the award on the panel’s lack of authority to render the award in the way it did.

7.  
**Conclusion**

49. In short, ICM respectfully requests that this Court vacate the panel's award of May 21, 2007.

Respectfully submitted,

**SIEGMYER, OSHMAN & BISSINGER LLP**

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