JOHN OLAGUES TRADING v. FIRST OPTIONS OF CHICAGO

588 F. Supp. 1194 (1984) | Cited 0 times | N.D. Illinois | June 22, 1984

MEMORANDUM ORDER

Before the Court is defendant's motion to dismiss the complaintfor injunctive relief and defendant's emergency motion requestinga stay pending arbitration.[1] Plaintiffs' allege violations of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(hereinafter "the Exchange Act"), and Rules 10b-4 and 10b-5thereunder, 17 C.F.R. § 240.10b-4, 10b-5. Defendant argues thatthis Court lacks jurisdiction because the complaint fails tostate a federal private cause of action.

For the reasons stated herein, the Court grants defendant'smotion to dismiss Counts I and III and grants defendant's motionto stay Counts II and IV.

I. FACTS

The following facts are alleged in plaintiffs' amendedcomplaint for injunctive relief. For purposes of this order theyare considered to be true.

A. Rule 10b-4 Allegations

On or about May 14, 1984, Teledyne, Inc., (hereinafter"Teledyne") offered to purchase back five million shares of itsstock for $200 per share. The proration date was set as May 25,1984, at 3:00 p.m., Los Angeles time[2] and the expiration date wasset as June 4, 1984, at 3:00 p.m.

Plaintiffs John Olagues Trading Company (hereinafter "OTC") andM. Blair Hull (hereinafter "Hull") are registered securitiesbrokers/dealers under § 15 of the Exchange Act and are"market-maker members" of the Chicago Board Options Exchange(hereinafter "the Exchange"). Defendant First Options of Chicago,Inc. (hereinafter "First Options") is a broker/dealer, a"clearing member" of the Exchange and at all relevant times"cleared" the accounts of plaintiffs.

On or about May 22, 1984, First Options agreed to assist Hullin avoiding risk or problems with respect to the Teledyne tenderoffer. On May 25, 1984, between 11:00 a.m. and 1:30 p.m.,following a personal review of his account at First Options withrespect to his position in Teledyne, Hull requested preparationof a tender notice for approximately 15,000 shares. Hull's reviewerroneously considered 44 short call options as not beingassigned. At 11:45 a.m., Hull's employee was informed by FirstOptions that it had prepared an "exercise notice" for certain ofHull's "long call options contracts" in Teledyne. Hull, based inpart on information supplied by First Options, amended the tendernotice to First Options to read 24,800 Teledyne shares whichbecame a contract to sell or otherwise dispose of securities.

At 3:02 p.m., two minutes after Teledyne's proration date, aHull employee telephoned First Options to amend the "notice"to reflect Hull's error to the extent that Hull was short 4,400shares of Teledyne (the 44 short call contracts). Due to thiserror the tender notice should have only been for 20,400,assuming no "assignments." A First Options' employee, however,stated that the "window" had closed two minutes earlier and thusnothing could be done. The employee further stated that it wasmuch better to tender all of Hull's Teledyne shares and be shortthe number of shares tendered on May 25, 1984, than for Hull notto tender all of his shares of Teledyne. The First Options'employee urged Hull's employee not to worry.

Hull notified First Options again on May 25 of the erroneoustender based not only on the 4,400 share computer error, but alsoon First Options' failure to notify Hull of the assignment ofcertain "call options contracts" in Teledyne. After the "calloptions contracts" were considered, Hull was at least 19,200shares short.

On May 25, 1984, plaintiff OTC entered into an oral contractwith First Options whereby First Options was to tender, on OTC'sbehalf, 23,800 Teledyne shares to Teledyne pursuant to Teledyne'stender offer. On or before May 29, 1984, First Options informedHull that it had notified Teledyne that 24,800 of Teledyne sharesfor Hull would be delivered pursuant to the tender offer.

Between May 29, 1984 and June 8, 1984, OTC orally informedFirst Options that the contract was based on a unilateral mistakeof fact in that OTC owned, and thus could deliver, only 14,600"net long" Teledyne shares and not the 23,800 as originallystated. OTC informed First Options that the May 25 contract wasillegal in that the contract violated Rule 10b-4 and thattherefore no contract existed.

Both Hull and OTC told First Options not to tender any Teledyneshares they did not hold, own or control. First Options, however,continued to state that there was no problem with a "shorttender" and that plaintiffs should tender all of their Teledyneshares and thus be "net short" as opposed to failing to tender atleast all of the Teledyne shares they owned by rescinding thetender. Plaintiffs relied upon assurances of First Options'employees that the short tender would never be a problem and thatthey would not be called upon to deliver the extra shares.

On June 12, 1984, Teledyne informed First Options that FirstOptions must deliver 93,000 additional shares of Teledyne, thetotal amount which First Options had not tendered as of thatmorning. On June 13, 1984, Hull and OTC were notified by FirstOptions that it intended to buy 19,200 Teledyne shares and 9,200Teledyne shares respectively for their two accounts after theclose of business at an undisclosed price to satisfy FirstOptions' obligation to Teledyne.

Plaintiffs individually notified First Options on June 13,1984, not to tender any shares they did not currently own orcontrol for the following reasons:

1) That the contracts between plaintiffs and First Options werevoid and nonenforceable in that they were illegal contracts and,further, were based upon a mistake of fact;

2) That First Options violated Rule 10b-4 in that it had beeninvolved in a short tender in violation of SEC Rules andRegulations;

3) That plaintiffs orally demanded that First Options not takeany action which would appear to affirm or ratify plaintiffs'original tender of May 25, 1984;

4) That on May 25, 1984, plaintiffs did not "own" a sufficientnumber of Teledyne shares to meet the May 25, 1984 tender offer,First Options knew plaintiffs did not own the shares, andplaintiffs did not give First Options any information that wouldpermit them to reasonably believe that plaintiffs would be ableto deliver the shares tendered on May 25, 1984.

B. Rule 10b-5 Allegations

Plaintiffs' allegations of Rule 10b-5 violations in Counts IIand IV reallege and incorporate the facts under the Rule 10b-4sections. In addition, plaintiffs allege that their contractswith First Options are voidbecause First Options violated Rule 10b-5 by directly being aparty to a scheme, device, and artifice to defraud by virtue ofits actions, statements and omissions.

On or about May 25, 1984, First Options told Teledyne that Hullwould tender 24,800 shares knowing that Hull was at least 4,400shares short and could possibly be as much as 19,200 shares shortdue to the number of Hull's short Teledyne call options contractswhich would be assigned. First Options made the offer to Teledyneknowing that the window was closed and that Hull was thusprecluded from correcting errors in his tender.

On or about May 25, 1984, and May 29, 1984, First Options madefalse statements of facts to plaintiffs. These includedstatements that it was better to be short the tender than not totender all the shares which plaintiffs' owned and that plaintiffswould not be called upon to tender more shares than they actuallyowned. Moreover, First Options failed to inform plaintiffs whenthey made their respective offers to tender that:

1) Teledyne could demand all shares tendered;

2) First Options was also an agent for Teledyne;

3) Many of First Options' "market makers" held Teledynepositions which could cause a "squeeze" in the market and make itdifficult for plaintiffs to borrow the Teledyne stock necessaryto satisfy their

tenders;

4) SEC Rule 10b-4 had been recently amended and that theamendment might effect plaintiffs' transactions.

Plaintiffs seek injunctive relief concerning First Options'alleged violations of Rules 10b-4 and 10b-5.

II. DISCUSSION

A. Motion to Dismiss

Rule 10b-4 was adopted by the Securities Exchange Commission in1968[3] for the purpose of prohibiting "short tendering." It wasthus designed to prohibit the practice of "tendering more sharesthan a person owned in order to avoid or reduce the risk of prorata acceptance in tender offers for less than all of theoutstanding securities of a class or series." Securities ExchangeAct Release No. 20799 (March 29, 1984). When an offer to purchaseis made by someone like Teledyne, and more shares are offered byowners like plaintiffs than are desired by Teledyne, Teledyneaccepts only a percentage of the stocks tendered by eachstockholder. Therefore, some tendering shareholders havetraditionally "short tendered," that is they tender more sharesthan they actually own in order to have more of their sharesaccepted after proration. Rule 10b-4 protects those tenderingshareholders, who tender only the amount of shares which theyactually own, from the dilution of their pro rata acceptance byvirtue of "short tendering" by other shareholders.

In Cort v. Ash, 422 U.S. 66, 95 S.Ct. 2080, 45 L.Ed.2d 26(1975), the Supreme Court set forth four requirements for theimplication of a private right of action under a statute likeRule 10b-4 which does not explicitly grant such a right: (1)plaintiffs must be "one of the class for whose especial benefitthe statute was enacted," (emphasis in original); (2) there mustbe a legislative intent to create such a remedy; (3) implying theprivate remedy must be "consistent with the underlying purpose ofthe legislative scheme," and (4) the private remedy must not beone that is traditionally relegated to state law. Id. at 78, 95S.Ct. at 2088. Ultimately, the question is one of legislativeintent. Mid-America National Bank v. First Savings and Loan,737 F.2d 638, 639-40 (7th Cir. 1984).

Clearly, Rule 10b-4 was enacted to protect shareholders whotender only the amount of shares which they actually own fromdilution of their pro rata acceptance caused by "short tendering"of other shareholders. Here, neither plaintiff is able to allegethat his offer was diluted by such a practice. Therefore,plaintiffs are notmembers of the class meant to be protected by Rule 10b-4 andtherefore fail to state a private cause of action under Rule10b-4. Accordingly, Counts I and III are dismissed.

B. Motion to Stay

In Counts II and IV of the amended complaint, plaintiffs chargeFirst Options with violating Rule

10b-5 and seek injunctiverelief. First Options argues that Counts II and IV should bestayed pending arbitration.[4]

All the parties to this action are members of the Chicago BoardOptions Exchange. In addition, OTC and Hull are parties toseparate but identical "Market-Maker's Agreements" with FirstOptions.

Both the Exchange Rules and the Market-Maker's Agreementprovide for arbitration of disputes. Chicago Board OptionsExchange Rule 18.1(a) provides:

Any dispute, claim or controversy arising between parties who are members or persons associated with a member which arises out of the exchange business of such parties shall, at the request of any such party and the approval of the exchange's director of arbitration, be submitted for arbitration in accordance with these rules.

In addition, the Market-Maker's Agreement provides:

It is agreed that any controversy between us arising out of the undersigned's business or this agreement . . . shall be submitted to and determined by arbitration conducted under the provisions of the constitution and rules of the Chicago Board Options Exchange, Inc. or other national securities exchange or pursuant to the Code of Arbitration of the National Association of Securities Dealers, as the undersigned may elect.

The United States Arbitration Act, 9 U.S.C. § 1 et seq.,(hereinafter "the Arbitration Act"), recognizes a strong federalpolicy favoring arbitration as an alternative dispute resolutionprocess and as the upholding of private contractual obligations.Moses H. Cone Memorial Hospital v. Mercury Construction,460 U.S. 1, 24, 103 S.Ct. 927, 941, 74 L.Ed.2d 765 (1983). The ArbitrationAct applies to a written provision in a "contract evidencing atransaction involving commerce to settle by arbitration acontroversy thereafter arising out of such contract." 9 U.S.C. § 2.The Arbitration Act provides that arbitration agreements,within its scope, "shall be valid, irrevocable, and enforceable."Id. The Arbitration Act further provides that, upon applicationof a party who is not in default in proceeding with arbitration,the court shall stay the trial of the action until arbitration ishad in accordance with the terms of the parties' agreement. Id.at § 3. Recently, the Supreme Court, in Moses H. Cone MemorialHospital v. Mercury Construction Corp., 460 U.S. 1, 103 S.Ct.927, 74 L.Ed.2d 765 (1983), commented:

The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay or a like defense to arbitrability.

Id. 103 S.Ct. at. 941-42.

In Wilko v. Swan, 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed. 168(1953), the Supreme Court held that, in a suit by a customeragainst a brokerage firm, the "non-waiver" provision of Section14 of the 1933 Act rendered the arbitration clause void. Ininterpreting Wilko, however, the Fifth Circuit has stated that,in light of 15 U.S.C. § 78bb(b), there is no reason to extend thenonwaiver provision beyond cases involving ordinary investors, todisputes between stock exchange members. Tullis v. Kohlmeyer &Co., 551 F.2d 630, 638 (5th Cir. 1977).

In Brown v. Gilligan, Will & Co., 287 F. Supp. 766 (S.D.N.Y.1968), the court considered an action under both the 1934 and1933 Acts between members of the AmericanStock Exchange. The court found the Wilko decision inapplicableto a suit between members of an exchange, reasoning that ifSection 78cc(a) stood alone, the parties' agreement to arbitratewould be void. The court concluded that, to the contrary, ifeffect is to be given to Section 78bb(b), an arbitrationagreement between exchange members must be enforced. Id. at774-75. Based on that reasoning, the court enforced thearbitration clause at issue. The Second and Fifth Circuits havesupported the Brown doctrine as to the effect of nonwaiverprovisions on arbitration clauses, as applied to exchangemembers. See Tullis v. Kohlmeyer & Co., 551 F.2d 632 (5th Cir.1977); Alexrod & Co. v. Kardich, Victor & Neufeld, 451 F.2d 838(2nd Cir. 1971). See also Coenen v. R.W. Pressprich & Co.,453 F.2d 1209, 1211-12 (2nd Cir. 1972); Bear v. Hayden Stone, Inc.,526 F.2d 734, 736 (9th Cir. 1975); Himebaugh v. Smith,476 F. Supp. 502, 506-07 (C.D.Cal. 1978).

Arbitration in this case is appropriate because the partieshave agreed to be bound by the rules of the Exchange and haveentered into a contract providing for arbitration. It isconsistent with Congressional intent to preserve the Exchange'sself-regulatory powers by enforcing arbitration provisions andremoving its members' disputes from the courts. See Coenen v.R.W. Pressprich & Co., 453 F.2d 1209, 1212 (2d Cir. 1972). Here,enforcement of the arbitration provisions would not only reflectthe parties' contractual intent and obligations, but wouldfurther the policies that Congress sought by enacting theArbitration Act and 15 U.S.C. § 78bb(b). Plaintiffs' argumentthat arbitration is inappropriate due to plaintiffs' prayer forinjunctive relief is without merit. Although the Court grantedplaintiffs' motion for a temporary restraining order, uponreflection, it is readily apparent that plaintiffs' allegedinjuries may be redressed adequately with damages relief. Anarbitrator can give such relief. Accordingly, Counts II and IVare stayed pending arbitration between the parties.

CONCLUSION

Counts I and III are dismissed for failure to allege a federalcause of action under Rule 10b-4. Counts II and IV, allegingviolations of Rule 10b-5, are dismissed without prejudice pendingarbitration. The Court does not express any opinion on the meritsof issues which may be presented to the arbitrator.

IT IS SO ORDERED.

1. Plaintiffs' original complaint predicated federal jurisdictionon alleged violations of Rule 10b-4. After defendant moved

todismiss the original complaint for lack of federal jurisdiction,plaintiffs amended their complaint to add violations of Rule10b-5. (See Counts II and IV of amended complaint.) Since neitherparty has addressed the Rule 10b-5 counts in their briefs, theCourt will consider defendant's motion to dismiss as directedsolely at the Rule 10b-4 counts (Counts I and III). Defendant'smotion for a stay, however, will be considered directed at allcounts in the amended complaint.

2. Unless otherwise noted, all times are given in Los Angelestime.

3. Securities Exchange Act Release No. 8321 (May 28, 1968), 33Fed.Reg. 8269 (1968).

4. See supra, n. 1.