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The (Fictional) Case of *Member Firm v. Thomas Hobson* – or why FINRA Rules Should Be Modified to Provide for Automatic Offset of Damage Awards to Opposing Parties to Prevent Unfair Choices

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"Hobson's choice: a situation in which you are supposed to make a choice but do not have a real choice because there is only one thing you can have or do." Merriam-Webster.com

Consider the following scenario. A member firm files a FINRA arbitration claim against an associated person to recover the defaulted balance on a promissory note. Call him Thomas Hobson.[1] Hobson has fallen on hard times since leaving the member firm and is unable to repay the balance. He files an answer to the claim along with several counterclaims.

The case goes to hearing and a sympathetic arbitrator issues a compromise Award. She awards the full defaulted balance to the firm, but also awards Hobson a lesser amount on his counterclaim. Assume the award on the firm's claim is $250,000 and the award on the counterclaim is $100,000.

The result is a net award of $150,000 to the firm (and that likely was the arbitrator's intent). But also assume the Award does not specify that the result is that Hobson must pay the firm $150,000. The Award simply states that the firm is awarded $250,000, Hobson is awarded $100,000 and all other relief is denied.

After receiving the Award, the member firm contacts Hobson and suggests he cut the firm a check for $150,000. Hobson has other ideas. He says that he does not have the money to pay the firm anything, but still expects a check from the firm for $100,000. Hobson even has the chutzpah to cite IM-13000 stating that a member firm's failure to honor an Award may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2010. Hobson himself can avoid having his license suspended for nonpayment by showing his inability to pay.

The firm is thus faced with the unappetizing options of (a) refusing to pay Hobson and risking that he will complain to FINRA, (b) paying Hobson $100,000 and trying to collect the $250,000 from him, (c) filing additional legal proceedings to correct or modify the Award. In such a scenario, a member firm's only realistic option is to incur the additional legal expense to moving to correct or modify the Award. A true Hobson's choice.

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[1] Per Wikipedia, "The phrase [Hobson's choice] is said to originate with Thomas Hobson (1544–1631), a livery stable owner in Cambridge, England. To rotate the use of his horses, he offered customers the choice of either taking the horse in the stall nearest the door or taking none at all."

Although the *Hobson* case reads like a law school hypothetical, the problem is real. *Securities Arbitration Commentator* ran a search covering the period April 2013 – April 2015 for FINRA Awards with money damages awarded to both claimant on its primary claim and to respondent on a counterclaim. Roughly 25% of the Awards issued during that two-year period with money damages to opposing parties contained no direction from the panel regarding whether the damage awards were intended to off-set.

FINRA Dispute Resolution staff members have recognized the potential for confusion and have advised arbitrators that they have the option of providing specifically for offset in the award. In *The Neutral Corner* (Volume 4-2008), Avi Badash observed that "in some awards, arbitrators may order opposing parties to pay each other monetary damages." He further noted that "[t]he Code does not contemplate automatic payments of the net difference of awards (commonly referred to as offsets)."

As such, "[w]ithout further clarification from the panel, the parties may wonder whether the panel intended for each part to pay the full amount or for the party who owes the higher amount to pay the net difference." Mr. Badash cautioned, however, that absent clear language to the contrary in the award, the obligations to comply with the award are separate and independent and that a party must pay the other party the full gross amount awarded even if it has no assurance it will receive payment in return.

Mr. Badash noted that this scenario could lead to an issue of "fairness." He therefore encouraged arbitration panels to "avoid ambiguity regarding payment" by "indicating whether each party should pay the other or offset the awarded amounts." For example, a panel intending a net award would specify in the award that "[t]he above amounts are offset. Respondent is liable for and shall pay to Claimant the sum of [the net award]." He also suggested that if for some reason the panel's intent is for the payment obligations to be independent of each other, the panel should so specify.

FINRA recently repeated this guidance in *The Neutral Corner* (Volume 1 – 2013), citing Mr. Badash's article and stating that "FINRA encourages arbitrators to clarify whether each party should pay the other or offset the awarded amounts."

FINRA should go a step further than merely encouraging arbitrators to be clear in their Awards as to whether offset is intended. The burden should not be on the arbitrators to keep up on their reading of *The Neutral Corner* so they know to craft their Awards to be specific on this relatively subtle point. Nor should claimants have to take the risk of addressing the offset issue in their closing arguments since it could be taken as admission that an award on the counterclaim is warranted or at least likely. Rather, the Code should be amended to flip the presumption around and provide that, absent specification to the contrary in the Award, monetary awards to opposing parties shall offset and that the party that owes the larger amount shall pay the net difference.

Such an amendment would preserve the flexibility for panels to provide for non-offsetting awards if for some reason the panel feels that is warranted. Such circumstances would seemingly be rare. But absent such unusual circumstances and clear direction from the panel, monetary awards to opposing parties would offset.

Whether this amendment should be made for all FINRA Dispute Resolution arbitrations is something that should be discussed. It could be limited initially to proceedings under Rule 13806 of the Industry Code, which governs claims involving promissory notes. The need for reform seems clearest there and typically

will not present the potential complication of multiple parties. Or the amendment could be limited simply to cases filed under the Industry Code since industry cases do not involve some policy concerns inherent in cases involving public customers.

Another option – and likely an easier one – would be to modify IM-13000 (Failure to Act Under Provisions of Code of Arbitration Procedure for Industry Disputes). The real risk to the member firm in the above scenario in refusing to cut a check to Hobson isn't that Hobson will move to enforce the award in court but that Hobson will complain to FINRA. This risk could be cured by modifying IM-13000 to specify that damages awards to opposing parties will be presumed to offset absent specification to the contrary in the Award.

IM-13000 currently provides: "All awards shall be honored by a cash payment to the prevailing party of the exact dollar amount stated in the award." Arguably the party receiving the larger of the offsetting damage awards is the "prevailing" party and is entitled to receive a cash payment for the net award in its favor. IM-13000 could thus be amended to specify that "Absent specification to the contrary by the panel, awards of damages to opposing parties will be deemed to offset and shall be satisfied by the party awarded the lesser amount making a cash payment for the net award to the party awarded the larger amount."

Such an amendment to IM-13000 would foil Hobson's game playing with the firm. The member firm could refuse to cut him a check, confident that FINRA would not find it to be in violation of its obligations under FINRA rules. Hobson – instead of the firm – would face his own unappetizing choices.