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ARTICLES

King v. Kovack Securities Creates Four Key Implications for Transfers of Customers and Registered Representatives of Failed Broker-Dealers

A recently concluded case in the U.S. District Court for the Northern District of Georgia raises important implications for securities attorneys and their clients involved in transfers of registered representatives and clients from a failed broker-dealer.

By G. Wayne Hillis Jr. and Justin P. Gunter

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The Facts

In September 2014, a Financial Industry Regulatory Authority (FINRA) arbitration panel entered an almost $3.9 million award against Resource Horizons Group (RHG), an independent contractor model broker-dealer. The award placed RHG in violation of the U.S. Security and Exchange Commission's (SEC's) net capital rule, 17 C.F.R. § 240.15c3-1, which generally requires broker-dealers to maintain at all times a specific net capital "cushion." The net capital deficiency forced RHG and all of its registered representatives to cease operating immediately. Under the net capital rule, registered representatives were prohibited from servicing customers' accounts, entering orders, or generating commissions. Customers were limited to liquidating orders placed directly with RHG's clearing firm.

Unable to cure the net capital violation, RHG's principals decided to wind down the business. They asked Kovack Securities, another independent contractor model broker-dealer, if it could accept the RHG registered representatives and customers who desired to transfer. Kovack Securities agreed to accommodate the transfers. Given the exigencies of the situation, RHG and Kovack Securities sought FINRA's review and approval of an expedited bulk transfer of registered representatives' registrations and a mass transfer of their customers' accounts through a "negative consent" process. In the continuing membership application RHG submitted to FINRA, RHG disclosed the unpaid arbitration award, that Kovack Securities was accepting RHG's registered representatives and their customers as an accommodation, and that Kovack Securities was not acquiring any of RHG's assets and would not be paying any consideration for the transfers. FINRA approved the application, and some 185 of RHG's 210 registered representatives transferred to Kovack Securities, along with most of their customers' accounts.

The Case

Four years later and unable to collect fully on the arbitration award, the arbitration claimants sued Kovack Securities in federal court asserting a fraudulent transfer claim under the Georgia Uniform Fraudulent Transfers Act (UFTA). The plaintiffs alleged that RHG's customer accounts and an "attendant right to manage" those accounts were RHG's "assets" and that RHG had fraudulently transferred those "assets" to Kovack Securities while RHG was insolvent and without receiving fair consideration. The plaintiffs sought damages in an amount equal to the unpaid award with accrued interest and attorney fees. Kovack Securities initially moved to dismiss the complaint for failing to state a claim, arguing that the customer accounts were not property owned by RHG and thus were not "assets" as defined by the UFTA. The court denied the motion, holding that the plaintiffs' complaint—accepting the allegations to be true—stated a plausible claim under the UFTA. In issuing this ruling, the court relied on two unpublished decisions in which other courts had held that, at least under the facts presented in those cases, a broker-dealer had some "interest" in its customers' accounts that could support a fraudulent transfer claim. *See Togut v. RBC Dain Correspondent Servs.*, 435 B.R. 866 (Bankr. S.D.N.Y. 2010); *Klatte v. Buckman*, No. 14-0699, 2016 WL 1090437 (D.N.J. Mar. 21, 2016).

After the close of discovery, Kovack Securities moved for summary judgment on all claims, arguing that the evidence established that RHG's customer accounts and its alleged interest in those accounts were not "assets" as defined by the UFTA. The court agreed, granted the motion for summary judgment, and entered judgment in favor of Kovack Securities on all claims. *King v. Kovack Sec., Inc.*, No. 1:18-CV-04079-SCJ, 2021 WL 5068393 (N.D. Ga. Sept. 28, 2021).

The court reasoned that a violation of the UFTA requires the transfer of an "asset," which is defined as "property of a debtor," and that "property" is defined as "anything that may be the subject of ownership." The court held that RHG's customer accounts and relationships did not constitute property or assets of RHG under the UFTA. While RHG certainly benefited from commissions on transactions in customer accounts, the evidence did not show that RHG owned or had a proprietary interest in those accounts. Rather, the evidence showed that the customers owned the accounts because they had the right to control and manage the accounts. Most important, RHG could not dispose of or transfer the accounts without some form of consent from the customers, whereas customers could terminate or transfer their accounts at will.

Accordingly, the court held that "RHG did not own, have a proprietary interest in, or have an adequate right to manage customers' accounts to render those accounts 'assets' under the UFTA." As a result, RHG did not commit a fraudulent transfer when it facilitated the mass transfer of customers' accounts to Kovack Securities. The court further emphasized that the manner in which RHG handled the transfers reinforced the court's conclusion that the accounts were not RHG's "assets." RHG did not simply transfer the accounts without permission as if it owned them, but instead presented registered representatives and customers with the facts and gave them the option to opt out of the transfer.

The plaintiffs appealed the decision to the Eleventh Circuit Court of Appeals and voluntarily dismissed the appeal in October 2022 following a confidential settlement. Consequently, the district court's summary judgment decision remains valid law and has four key implications for securities attorneys and their clients involved in transfers of registered representatives and clients from a failed broker-dealer.

The Implications

Facts Remain Critical

Although Kovack Securities argued that the customers of a failed broker-dealer are not its property for purposes of the UFTA as a matter of law, the *King* decision ultimately relied on the case-specific facts to hold that the customer accounts were not RHG's "property" under the

Georgia UFTA. As this case and the decisions in *Togut* and *Klatte* demonstrate, the facts of a given case may be outcome-determinative until a more extensive body of law develops. Counsel advising clients on transfers of customer accounts and registered representatives from a failed broker-dealer should pay careful attention to the specific nature and details of the proposed transfers when assessing the risks of a fraudulent transfer claim. For example, broker-dealers often refer to customer accounts colloquially as an "asset," and asset acquisitions of even financially healthy broker-dealers typically include agreements on the transfer of registered representatives and customer accounts. Yet, the word "asset" under the UFTA means "property of a debtor." Counsel should advise their clients to use precise language when describing or referring to registered representatives and customers in connection with any transfer or acquisition.

Likewise, counsel defending against a fraudulent transfer claim should pay careful attention to developing the detailed facts regarding the nature and extent of the relationship between the customers and the failed broker-dealer. In the *King* case, the court based its decision on the evidence about the nature and extent of RHG's relationship with its independent contractor registered representatives and their retail customers. The evidence showed that the customers' relationships, dealings, and allegiance truly were with the registered representatives, not RHG. These facts, along with the terms of the account agreements between RHG and the retail customers, RHG's inability to sell or convey the customer accounts, and the customers' ability to close or transfer their accounts at will, were critical to the court's decision.

FINRA Approval Is Not Necessarily a Safe Harbor

Counsel should remember to advise their clients that FINRA approval does not necessarily mean that a contemplated transaction complies with *all* applicable laws. When advising regulated broker-dealers, it is all too easy for counsel to develop tunnel vision, focusing on complying with SEC and FINRA rules while ignoring other potentially applicable state laws. The defendants in the *King* case took the required step of seeking and receiving FINRA approval for the transfers. As the *King* case illustrates, however, just complying with FINRA's rules and obtaining FINRA's blessing did not necessarily insulate Kovack Securities from potential liability under Georgia's UFTA. Even in an actual acquisition approved by FINRA in which a broker-dealer pays to acquire a financially troubled broker-dealer, the acquiring firm still could be subject to a fraudulent transfer claim alleging that it did not pay enough. Counsel should advise their clients of these risks when evaluating a potential accommodation or acquisition of a financially troubled firm.

Preemption

Although FINRA approval is not currently a "safe harbor," one remaining question following the *King* decision is the extent to which the FINRA rules preempt state fraudulent transfer laws. In the same summary judgment motion, Kovack Securities argued that FINRA rules (which are promulgated under the authority of the SEC and pursuant to the Securities Exchange Act of 1934) have federal preemptive effect and vest FINRA with the exclusive authority to review and approve bulk transfers of broker registrations and customer accounts from failed broker-dealers. Kovack Securities argued that state fraudulent transfer laws, like the Georgia UFTA, are therefore preempted to the extent they declare illegal a transfer that FINRA expressly approved. The court in *King* did not reach this argument, and it remains unresolved.

The issue remains of critical importance, however, for protecting the customers of a failed broker-dealer. As courts have recognized in other contexts (such as the clients of a failed law firm), treating customers of an insolvent firm as its "assets" greatly impairs customers' ability to move their accounts and business elsewhere. Under the *King* plaintiffs' theory, any firm accepting the customers' accounts would have to pay the insolvent firm and could still be the target of claims that it had not paid enough. Creditors could effectively hold a failed broker-dealer's customers hostage for the payment of the failed broker-dealer's debts. Applying state fraudulent transfer laws in such a manner conflicts with FINRA rules recognizing the customers' rights to control where they do business and FINRA's authority over failed broker-dealers, including those with unpaid arbitration awards. It also impairs FINRA's ability to regulate the transfers of representatives and customer accounts and to fulfill its mandate of customer protection. A ruling that the FINRA rules preempt any contrary application of state fraudulent transfer laws would protect FINRA's ability to regulate the transfer of brokers' registrations and customers' accounts to other firms and encourage broker-dealers to step in and accommodate expedited transfers in order to protect customers.

Serving as a White Knight Is a Risky Business

Even in the best of cases, accommodating the customers of a failed broker-dealer entails both legal and economic risk, and counsel should advise their clients on these risks when evaluating whether to participate in such an accommodation. The failure of a broker-dealer creates a dire situation for the customers and registered representatives of the failed firm. In the case of a net capital violation, the firm and its registered representatives are precluded from doing business, including recommending trades and receiving commissions, and customers are limited to making unsolicited liquidation-only orders. In short, customers lose effective access to their investments and are exposed to market risk, while registered representatives are left unable to service their customers and earn a living at the failed firm. In such a situation, both customers and registered representatives urgently need to move to a new broker-dealer. The traditional process for a registered representative to find a new firm, negotiate employment terms, and contact and solicit customers to transfer is time-consuming and can take several months to complete.

A broker-dealer asked to accommodate these orphaned registered representatives and customers on an expedited basis will certainly see an opportunity to expand its business. FINRA likewise is often eager to have a reputable firm accept the orphaned customers, thus reducing customers' exposure to market risk and advancing FINRA's investor protection mission. Yet, given the exigencies of the situation, an accommodating broker-dealer may lack sufficient time to conduct nearly the same level of due diligence on the transferring registered representatives and their customers as it would in normal circumstances. An accommodating firm may be accepting future civil or regulatory risk that cannot be fully appreciated or quantified at the time.

Moreover, in such an exigent situation, an accommodating firm may be unable to negotiate individual retention deals or restrictive covenants with each accommodated registered representative, or may be unable to know how many customers and registered representatives will wait long enough for the accommodation to be approved by FINRA and completed. Many registered representatives (especially veteran registered representatives with other opportunities) may not accept the accommodation to begin with, and even those who do transfer may use the accommodating firm merely as a "stop gap" to give them a temporary place to do business while taking the time necessary to find a new permanent home. Thus, while serving as a "white knight" does provide a broker-dealer with an enticing opportunity to quickly expand its business (at least in the short term), an accommodating firm takes on additional risk and expense with little certainty as to the long-term benefits, if any. Counsel should advise their clients to account for these risks before proceeding with such an opportunity.

G. Wayne Hillis Jr. and Justin P. Gunter are partners at Parker, Hudson, Rainer & Dobbs LLP in Atlanta, Georgia.

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