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ORIGINAL

U.S. DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
FILED
JUL 16 2001
CLERK, U.S. DISTRICT COURT
By _____ Deputy

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

SECURITIES AND EXCHANGE COMMISSION Plaintiff, VS. FUNDING RESOURCE GROUP a/k/a FRG TRUST, ET AL. Defendants.	§ § § § § § § § § § §	NO. 3-98-CV-2689-M ✓
MICHAEL J. QUILLING, as Receiver for Hammersmith Trust, LLC, Hammersmith Trust, Ltd., Microfund, LLC, and B. David Gilliland Plaintiff, VS. MERRILL LYNCH PIERCE FENNER & SMITH, INC. Garnishee.	§ § § § § § § § § § § §	NO. 3-01-CV-0177-M

FINDINGS AND RECOMMENDATION OF THE UNITED STATES MAGISTRATE JUDGE

Michael J. Quilling, as Receiver for Hammersmith Trust, LLC and related entities, has filed a motion for contempt against Merrill Lynch Pierce Fenner & Smith, Inc. ("Merrill Lynch"). For the reasons stated herein, the motion should be granted.

I.

This contempt motion arises out of a lawsuit brought by the Securities and Exchange Commission against 16 defendants and 13 equity relief defendants involving the sale of non-

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existent "prime bank" securities. *Securities and Exchange Commission v. Funding Resource Group, et al.*, No. 3-98-CV-2689-M. In that case, the SEC alleges that defendants raised more than $14 million from unwitting investors by making false representations about the use and safety of investor proceeds and the expected rate of return on their investment. This conduct, if proved, constitutes a violation of the federal securities laws.[1] As relief, the SEC seeks a permanent injunction, disgorgement, and civil penalties against the defendants who actively participated in the fraud.

Michael J. Quilling is the court-appointed Receiver for all defendants and equity relief defendants in the *Funding Resource* case. On November 29, 1999, the Receiver obtained an emergency *ex parte* order freezing an account in the name of Jerrold Gunn at Merrill Lynch. That order provides, in relevant part:

> IT IS ORDERED that Account No. 75023822 in the name of Jerrold Gunn at Merrill Lynch is hereby frozen until further order of this Court.

ORDER FREEZING ACCOUNT, 11/29/99. The parties have stipulated that Charles V. Senatore, First Vice President of Merrill Lynch, received a copy of this order at his New York office on November 30, 1999. (Stip. ¶ 3).

The Receiver subsequently sued Gunn to recover monies traceable to defrauded investors. *Michael J. Quilling v. Jerrold Gunn, et al.*, No. 3-00-CV-1318-M. On December 14, 2000, the Court entered a final default judgment against Gunn in the amount of $10 million. The Receiver then filed a garnishment action against Merrill Lynch in an effort to collect assets toward

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[1] The SEC alleges violations of Sections 5(a), (c) & 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77c(a), (c) & 77q(a), Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5. (Plf. Third Am. Compl. ¶ 3).

satisfaction of the judgment. *Michael J. Quilling v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 3-01-CV-0177-M. On January 25, 2001, the district clerk issued a writ of garnishment to Merrill Lynch. The writ provides, in pertinent part:

> YOU ARE FURTHER COMMANDED NOT to pay to [Gunn] any debt or to deliver to him any effects, pending further orders of this Court.

WRIT OF GARNISHMENT, 1/25/01. C.T. Corporation System, the registered agent for Merrill Lynch, was personally served with a copy of the writ on January 30, 2001.

Despite actual notice of the freeze order and writ of garnishment, Merrill Lynch continued to allow trading in the Gunn account from December 1, 1999 through April 23, 2001. As a result, the account has diminished in value by $67,191.27. The Receiver contends that this conduct constitutes a violation of the freeze order and writ of garnishment.

A show cause hearing was held on June 29, 2001. Both sides appeared through their counsel of record and announced ready to proceed. Prior to the hearing, Merrill Lynch filed a written response to the contempt motion. The parties also submitted trial briefs, stipulations, and excerpts of deposition testimony. The Court has considered the evidence, briefs, and arguments of counsel, and the motion is now ripe for determination.

II.

A person who fails to obey a lawful court order may be punished for contempt. *Travelhost, Inc. v. Blandford*, 68 F.3d 958, 961 (5th Cir. 1995). In a civil contempt proceeding, the movant must establish that: (1) a court order was in effect; (2) the order required certain conduct by the respondent; and (3) the respondent failed to comply with the order. *See American Airlines, Inc. v. Allied Pilots Association*, 228 F.3d 574, 581 (5th Cir. 2000), *cert. denied*, 121 S.Ct. 1190 (2001), *citing Martin v. Trinity Industries, Inc.*, 959 F.2d 45, 47 (5th Cir. 1992). The

standard of proof is clear and convincing evidence. *Petroleos Mexicanos v. Crawford Enterprises, Inc.*, 826 F.2d 392, 401 (5th Cir. 1987). However, the conduct need not be willful so long as the respondent actually violated the court's order. *Allied Pilots*, 228 F.3d at 581.

Sanctions in a civil contempt proceeding may be awarded to compensate the movant for losses sustained as a result of the contemptuous conduct. *Id.* at 585, *quoting United States v. United Mine Workers of America*, 330 U.S. 258, 303-04, 67 S.Ct. 677, 701, 91 L.Ed. 884 (1947). A district court has broad discretion in assessing damages for civil contempt. *Id.*, *citing Long Island Rail Road Co. v. Brotherhood of Railroad Trainmen*, 298 F.Supp. 1347, 1350 (E.D.N.Y. 1969). "The purpose is to compensate for the damages sustained." *Id.*; *see also McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 191, 69 S.Ct. 497, 499, 93 L.Ed. 599 (1949).

A.

Merrill Lynch received the freeze order on November 30, 1999. (Stip. ¶ 3). The order was sent to Charles V. Senatore, Vice President of Merrill Lynch, at his New York office. (Rec. Exh. 6 at 064). Senatore forwarded the order to the legal department, where it was reviewed by Jackie Lamberti. (Houstone Dep. at 25, 27). On December 1, 1999, Lamberti entered the order on the Merrill Lynch computer system with the notation, "Acct Frozen Per Restraining Order from the Securities & Exchange Commission." (Rec. Exh. 6 at 062). Although the freeze order was directed to "Account No. 75023822 in the name of Jerrold Gunn," Lamberti apparently recognized this error and correctly entered the order under Account No. 750-23B22. (*Id.*) (emphasis added). The file then was assigned to Nicole Houstone, a litigation analyst, for further handling. (Houstone Dep. at 26).

Houstone testified that, upon receipt of the freeze order, she placed two types of restraints on Gunn's account. (*Id.* at 39). The first type of restraint blocks Visa transactions and the ability

to write checks. (*Id.* at 38). The second type is an internal flagging mechanism "to inform anyone who probably looked at the account that there is some type of restraint on it." (*Id.*). Houstone's responsibility is to "make sure [the account] is frozen everywhere." (*Id.* at 41). This includes sending information about the freeze to the local branch office handling the account. (*Id.* at 42). At her deposition, Houstone was asked:

> Q: Once you place this freeze on a particular account, then is the customer still allowed to trade in the account?
>
> A: Hmm--I'm not sure.
>
> That would be--um--usually, what I get is orders that say--it will specify there is no trading. That's when I inform the branch there is no trading, There would be no trading, transferring, encumbering, hypothecating.
>
> Q: Well, did "freeze" mean the same thing to you?
>
> A: A freeze by itself?
>
> Q: Yes, ma'am.
>
> A: A "freeze" would mean freeze to me. Um--that's what it would mean to me.
>
> I don't handle the accounts from this end. We are just the legal. We instruct them what--what we received and I guess--uh--whatever the order says, that's what I pass on to them.
>
> Q: And you passed that on to the branch manager?
>
> A: Yes.
>
> Q: Okay. And can you tell from your files, Ms. Houstone, who you would have told that this account is frozen?
>
> A: From my file? Um--usually, I will send it to the administrative manager and the broker, I would cc the broker, it would be via E-mail.

(*Id.* at 43-44).

Jeffrey C. Thompson, a broker in the Fort Lauderdale office of Merrill Lynch, is responsible for the Gunn account. At some point in time, Thompson became aware that Gunn's account had been frozen by a federal court in Dallas. (Thompson Depo. at 37). However, he never saw the computer entry made by Lamberti nor was this entry brought to his attention. (*Id.* at 39). Thompson testified that his understanding of the term "freeze" was "that nothing is to leave the account." (*Id.* at 46). Notwithstanding this order, Gunn was allowed to continue his trading activities. Merrill Lynch's own records show 39 different transactions in the Gunn account from December 1, 1999 through April 23, 2001. (Rec. Exh. 6 at 045). Many of these transactions were solicited by Thompson or other brokers at Merrill Lynch. (Thompson Depo. at 33-34). In addition, Merrill Lynch assessed and collected a quarterly fee based on the value of the account. (*Id.* at 63-64). Thompson continued to advise Gunn of investment opportunities until he was instructed not to do so by legal counsel. (*Id.* at 68).

B.

Merrill Lynch acknowledges "that there was some trading in an account maintained by Jerrold Gunn . . . over the time period in question." (ML Trial Brf. at 2). As justification for its actions, Merrill Lynch raises two defenses: (1) the freeze order was impermissibly vague and ambiguous; and (2) the order referenced a different account number. The Court will examine each defense in turn.

1.

Merrill Lynch first contends that the freeze order is unenforceable because it does not define the term "freeze." The Court disagrees. The plain and ordinary meaning of "freeze" is "to cause to become fixed, immovable, unavailable, or unalterable." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY at 465 (10th ed. 2000). Another definition, equally applicable to the

instant case, is "to prevent or restrict the exchange, liquidation, or granting of by law--i.e. banks that agreed to *freeze* investment loans." WEBSTER'S II NEW COLLEGE DICTIONARY at 446 (1995). Although Merrill Lynch complains that the order is vague and ambiguous, the evidence suggests otherwise.

Jeffrey Thompson testified that he understood the term "freeze" to mean "that nothing is to leave the account." (Thompson Dep. at 46). Nevertheless, he interpreted the freeze order to allow trading in the Gunn account. According to Thompson, "until the client's name was taken off the account and had left, Merrill Lynch had the right to protect his principal." (*Id.* at 52). However, this interpretation was not based on the language of the freeze order. Rather, Thompson relied on some other document issued by the Internal Revenue Service five or six years ago in a completely unrelated case. (*Id.* at 48-51). He never claimed that the freeze order itself was unclear or susceptible to more than one interpretation.[2]

Merrill Lynch points out that the Receiver could have easily drafted the order in more precise terms to prohibit any financial institution or brokerage firm from "selling, transferring, pledging, hypothecating, delivering, loaning, or otherwise disposing of accounts or assets" in the name of Jerrold Gunn. Indeed, such language is typically used in freeze orders. *See, e.g. SEC v. Black*, 163 F.3d 188, 194 n.4 (3d Cir. 1998); *Elliott v. Kiesewetter*, 98 F.3d 47, 52 (3d Cir. 1996); *Anderson v. Stephens*, 875 F.2d 76, 77 n.3 (4th Cir. 1989); *Federal Trade Commission v. National Business Consultants, Inc.*, 1993 WL 293289 at *1-2 (E.D. La. July 23, 1993). However, the failure to specifically prohibit the transfer or hypothecation of assets does not render

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[2] Although Nicole Houstone testified that she was "unsure" whether the freeze order prohibited trading activities, this testimony is irrelevant because Houstone was not involved in the decision to permit trading in the Gunn account. The Court notes, however, that Houstone never told the broker that trading would be allowed. (Houstone Dep. at 44).

the freeze order unenforceable. The plain and ordinary meaning of the term "freeze" subsumes such conduct.

2.

Merrill Lynch further maintains that there is no evidence of contemptuous conduct because the freeze order applied to Account No. 75023822, while all trading activity was conducted in Account No. 750-23B22. This argument borders on frivolous. Merrill Lynch immediately recognized this typographical error when it received the freeze order. Not only did Jackie Lamberti enter the correct account number in the Merrill Lynch computer system, but all correspondence from the Receiver referencing the account was interlined with the proper account number. (Rec. Exh. 6 at 062, 065, 070, 074). Nor is there any evidence of actual confusion on the part of Merrill Lynch. To the contrary, Nicole Houstone testified that she "always knew which account number was being referenced regarding Mr. Jerrold Gunn at Merrill Lynch." (Houstone Dep. at 36).

C.

Merrill Lynch violated the freeze order by allowing Jerrold Gunn to trade in his account from December 1, 1999 through April 23, 2001. The evidence shows a total of 39 different transactions during the relevant time period. (Rec. Exh. 8). According to the Receiver, the account decreased in value by $67,191.27 as a result of this activity. (Rec. Exhs. 7, 10 & 11). Merrill Lynch has not adduced any evidence to the contrary. Therefore, Merrill Lynch should be ordered to pay $67,191.27 to compensate the Receivership Estate for its losses.

III.

The Receiver also seeks attorney's fees and expenses incurred in bringing this contempt motion. The itemized billing statements submitted by the Receiver document fees and expenses

totaling $10,086.58 through July 3, 2001. (Rec. Post-Sub. Brf., Exh. B). Merrill Lynch does not controvert this evidence. The Court has reviewed the billing statements and finds that the time spent, services performed, expenses incurred, and hourly rates charged by the Receiver are justified under the factors set forth in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974). No upward or downward adjustment is warranted. Accordingly, Merrill Lynch should be ordered to pay the Receiver $10,086.58 in reasonable attorney's fees and expenses.

RECOMMENDATION

The Receiver's motion for contempt against Merrill Lynch should be granted. Merrill Lynch should be held in contempt of court for violating the freeze order dated November 29, 1999, by allowing trading in Account No. 750-23B22 from December 1, 1999 through April 23, 2001.[3] Damages resulting from this contemptuous conduct total $67,191.27. In addition, the Receiver has incurred $10,086.58 in reasonable attorney's fees and expenses. Merrill Lynch should be ordered to pay these sums to the Receiver within 30 days after these findings are approved by the district judge.

DATED: July 6, 2001.

JEFF KAPLAN
UNITED STATES MAGISTRATE JUDGE

[3] In view of the disposition of this motion, the Court need not determine whether Merrill Lynch violated the Writ of Garnishment issued on January 25, 2001.