AMERICAN ARBITRATION ASSOCIATION
Commercial Arbitration Tribunal

In the Matter of the Arbitration between

ELLIOT C. LEVINTHAL, RHODA L. LEVINTHAL and THE ELLIOTT C. AND RHODA L. LEVINTHAL REVOCABLE TRUST DATED 10/09/80

Claimants

v.

FIRST REPUBLIC SECURITIES COMPANY, LLC

Respondent

AWARD OF ARBITRATORS

Re: AAA No. 30 435 Y 00218 09

DATE ON WHICH THIS CASE WAS FILED

This case was filed with the American Arbitration Association on March 20, 2009.

PARTIES, REPRESENTATIVES AND PANEL OF ARBITRATORS

The parties to this proceeding are those individuals and entities named in the foregoing caption, except that, as established by Mr. Levinthal's signature in evidence and by his counsel's usage in documents submitted to the Panel in this proceeding, the first name of the first named Claimant is "Elliott," not "Elliot." The correct spelling is used henceforth in this Award.

In their Submission Agreement in this matter, dated February 13, 2009, Claimants agreed in relevant part "not to name First Republic Investment Management, Inc. . . . and First Republic Wealth Advisors,

LLC . . . as parties in this arbitration proceeding" and Respondent agreed "that it shall be held liable for any misconduct or wrongful acts committed by [these First Republic entities] or any of their agents, employees or principals relating to Claimants." Accordingly, as used in this Award, the term "Respondent" includes both the captioned First Republic Securities Company, LLC and these other First Republic entities.

Claimants have been represented herein by Cary S. Lapidus, Esq., of the Law Offices of Cary S. Lapidus, San Francisco. Respondent has been represented by Lawrence E. Fenster, Esq. and Matthew C. Plant, Esq., of Bressler, Amery & Ross, New York.

The arbitrators duly appointed to serve in this proceeding are Bruce W. Belding, D. Steven Blake and Francis O. Spalding, Chair. The late Jeffrey A. Tidus, Esq., appointed as an original member and initial Chair of the Panel of Arbitrators, was tragically murdered in December 2009 (under circumstances bearing no evident connection whatsoever to this case). Before his death, Mr. Tidus presided over the first preliminary hearing herein; the case proceeded to its conclusion under the terms of Pre-Hearing Order No. 1, prepared by Mr. Tidus following that preliminary hearing and signed by him on behalf of the Panel.

NUMBER, DATES AND LOCATIONS OF HEARINGS IN THIS CASE

Two preliminary hearings were convened by conference call in this case, to address prehearing procedural issues, the first on July 7, 2009, and the second on March 29, 2010.

Thereafter, nine hearings on the merits were convened at the offices of the American Arbitration Association, One Sansome Street, San Francisco, CA, on April 5, 6, 7, 8 and 9, 2010, and on June 3, 4, 7, and 8, 2010.

TYPES OF SECURITIES AND ISSUES IN CONTROVERSY

This dispute between the parties arises out of Claimants' purchase from Respondent, in July 2007, of

an investment in the amount of $3,000,000 in a so-called Tender Option Bond program, involving a leveraged arbitrage strategy that included trades of long municipal bonds, short-term notes and interest-rate derivatives or swaps. This product, styled by Respondent the "TW Tax Advantaged Fund LLC" (referred to in this Award as "the Fund") was developed and sold to Claimants (and to other investors) by Respondent and certain of its affiliates including First Republic Investment Management, Inc. and First Republic Wealth Advisors, LLC.

SUMMARY OF ISSUES

Claimants claim that Respondent misrepresented some material facts concerning the Fund purchased from Respondent by Claimants, failed to inform Claimants of other material facts concerning the Fund, failed to perform due diligence with respect to the Fund as an investment product, and failed adequately to train and supervise its agents in the presentation and sale of the Fund. Claimants further contend that, in offering the Fund to Claimants, Respondent recommended to Claimants an investment unsuitable for them.

Claimants contend that Respondent, in its dealings with Claimants with respect to the Fund, breached its fiduciary duty to Claimants; that it was negligent; that it committed negligent misrepresentation, breach of contract, fraud and deceit, and elder abuse; that it failed to obey relevant proscriptions of the California Corporations Code; and that it violated certain FINRA Conduct Rules.

Respondent denies liability to Claimants on any and all of these theories. As discussed below, Respondent also claims entitlement to indemnity against Claimants for any losses that it may incur under this Award.

CLAIMANTS' DAMAGES CLAIMS

Claimants in their opening brief dated March 29, 2010, requested compensation for "all of the damages suffered as a result of Respondent's misconduct by a monetary award in an amount according to

proof and/or by rescission." The proofs submitted by Claimants have sought to establish that this monetary award should be in the amount of $2,100,000.00. Claimants further requested in their opening brief "an award of interest, attorneys' fees, the costs of this arbitration, punitive damages and such other relief as the Arbitrators deem just and proper."

Although Respondent disputes liability for Claimants' losses in any amount, it does not dispute that Claimants' losses from their investment in the Fund amounted to $2,100,000.00.

The interest sought in the exercise of the Panel's discretion under Civil Code Section 3288 is pre-judgment interest as "a necessary element of compensatory damages to insure that a plaintiff is made whole" at "the constitutional rate of 7 percent . . . ."

Claimants claim attorneys' fees under the California Elder Abuse & Dependent Adult Protection Act, California Welfare & Institutions Code, Section 15657.5 ("the Elder Abuse Act").

RESPONDENT'S DEFENSES AND CLAIM FOR AFFIRMATIVE RELIEF

Respondent contends that Claimants were, at the time of the transaction in issue, experienced investors willing and able to take risks; that Claimants were fully and appropriately informed by Respondent of the risks inherent in the Fund; that Claimants acknowledged those risks before purchasing that investment; and that Claimants did not act justifiably or reasonably in ignoring the warnings contained in the offering documents.

Respondent contends that its conduct and that of its agents and employees in their dealings with Claimants did not constitute any breach of fiduciary duty; negligence; negligent misrepresentation; breach of contract; fraud and deceit; elder abuse; or violation of any relevant proscriptions of the California Corporation Code; and did not breach any FINRA Conduct Rules.

Respondent also asserts a claim for affirmative relief under the indemnity provision of Section

1.14(b) of the Subscription Agreement signed by Claimants in connection with their purchase of the Fund, under which provision, Respondent contends, Claimants are obligated to hold Respondent harmless against Claimants' claims, the costs and expenses incurred by Respondent in defending against those claims, and any loss suffered by Respondent as a result of those claims.

DISCUSSION OF THE PARTIES' CLAIMS AND DEFENSES

1. **Claimants' Claims Denied by the Panel.**

Claimants claim that Respondent misrepresented some material facts concerning the Fund purchased from Respondent by Claimants, and that Respondent failed to inform Claimants of other material facts concerning the Fund. The Panel finds that there was no showing in the evidence that Claimants justifiably relied upon any particular such representation to their damage. This claim is denied.

Claimants claim that Respondent breached its contract with Claimants. No evidence of a particular breach of any contract between Claimants and Respondent was submitted. This claim is denied.

Claimants claim that Respondent committed fraud and deceit in its dealings with Claimants. No evidence was presented that established that Respondent was guilty of willful misrepresentation or of any other willful misconduct conduct constituting fraud or deceit by which Claimants were injured. This claim is denied.

Claimants claim entitlement to punitive damages as a consequence of Respondent's asserted common law fraud. Claimants' claims of fraud and deceit having been denied, there remains no basis upon which Claimants may claim punitive damages. This claim is denied.

Claimants claim that Respondent was guilty of elder abuse under the Elder Abuse Act, thereby entitling Claimants to recover their attorneys fees under that statute. The elements establishing liability or permitting recovery of attorneys' fees under that Act were not proven. This claim is denied.

Claimants claim that, in its dealings with Claimants with respect to the Fund, Respondent failed to

follow certain proscriptions of the California Corporations Code, and that Respondent violated certain FINRA Conduct Rules. These claims are denied.

As noted above, Claimants claim entitlement to be made whole by way of the award of pre-judgment interest. In the exercise of the Panel's discretion, it denies this claim made by Claimants, (which in the context of this proceeding it interprets to be a claim for pre-Award interest), on the ground that Professor Levinthal, son of the Trustors, co-trustee with them and their designated principal contact person with Ms. Pan, received and either read or had a full opportunity to read the offering materials relating to the Fund presented by Respondent; yet according to the evidence, he failed either to raise with Ms. Pan or with any other agent of Respondent, or otherwise to respond to, the risk warnings included in those documents—failings adverted to again below.

2. Claimants' Claims Granted by the Panel.

The Panel finds that the evidence submitted establishes the following factual claims made expressly, or by necessary implication, by Claimants:

A. Respondent failed to perform proper due diligence in designing the Fund.

There is ample room in the evidence to question the due diligence of those of Respondent's employees who designed the Fund. Even as they speak years after the event, their evident glibness in testifying about the development of the Fund hardly bespeaks an appropriate understanding of and respect for the huge loss-making potential that their creation proved to have. In the words of Respondent's opening brief, the "virtually unprecedented and wholly unforeseen dislocation" in the yield spread between taxable and tax-exempt bonds, said to be "part of an equally unforeseen credit crisis" are events that investment professionals study; and by definition professionals such as these are bound to know and understand not only such events but most particularly their potential for upsetting investment plans—even those that include securities spoken of as rock-solid, like high grade municipal bonds—far

better than their customers do. There were multiple references by Respondent's employees and expert in this field to the upsides offered by the Fund: profit-maximizing leverage, higher yields—and higher fees. The Panel heard no evidence concerning any realistic advance recognition by Respondent's staff of any specific risks or patterns of risk like those that became all too apparent *after* the Fund's collapse.

B. Respondent failed adequately to train its sales agents who dealt with Claimants to sell the Fund to them.

Sandra Pan was Respondent's principal contact person in its dealings with Claimants concerning the Fund. Ms. Pan's superiors included not only those who designed the Fund program but those who bore responsibility for training Ms. Pan and her colleagues to sell it. The training given to Ms. Pan by her superiors in order to prepare her to sell the Fund to clients such as Claimants was shown in the evidence to have been palpably deficient in preparing her to discharge those duties.

The Fund was described in a Private Placement Memorandum ("PPM"), introduced in evidence and frequently referred to in testimony and argument, that runs to approximately 65 single-spaced pages, including a "Summary of Terms" of approximately 13 pages and a single-page "Index of Defined Terms" listing references in the document to 81 such terms, including multiple references to 29 of these terms. The PPM establishes the immense complexity of the proposed Fund, involving as it did several separate components including "Residual Certificates issued in tender option bond programs" as well as "Hedge Agreements" intended to "mitigate . . . interest rate risks through proprietary hedging strategies." Put another way, the Fund comprised, among other possible interests, economically leveraged purchases of long fixed-rate tax-exempt municipal bonds; short-term borrowings to finance the leverage; and interest rate swaps and other like instruments intended to hedge interest rate risks of the short-term financing. The components employed by the Fund were to be interlocked in use in a strategy that had the potential, in the language of the PPM, to "generate attractive after-tax returns through economically leveraged investments in fixed-rate tax-exempt Municipal Bonds."

As events in this case proved, however, there were also potentials for some or all of the elements of the Fund to interact in reaction to market events in ways counter-intuitive to the customary expectations even of experienced and sophisticated investors—not to mention to deeply experienced investment professionals, almost certainly including Ms. Pan's superiors. For in the event in this case, within a few days in late February and early March of 2008, the Fund, under the management of these professionals, suddenly collapsed in such a way that Respondent concluded that its best—and perhaps its only—option was to liquidate the Fund entirely and to return the scant remains to its investors, including Claimants. As a consequence, almost overnight, Claimants lost $2,100,000.00—70 per cent of their investment in the Fund.

The evidence presented to the Panel demonstrated that the training materials that Ms. Pan and her colleagues actually received from Respondent were entirely inadequate both in scope and in content. These materials, consisting of a scant four pages, were scarcely explained even in the hearing before the Panel for which there had been months of opportunity to prepare. The focus of these four pages was a single graph that was far from comprehensive or comprehensible. Ms. Pan's trainings were said to have required two hours' time, but as to how this time was spent, how these training sessions were conducted or what if any training script or syllabus was followed—none of this was offered into evidence, apart from the briefest of references to the same four pages.

The most persuasive evidence of the utter inadequacy of the training given Ms. Pan, however, was in her testimony at the hearing, testimony that made it evident that, even with every opportunity for *post hoc* embellishment, she still scarcely understood the Fund.

C. Respondent failed adequately to supervise its sales agents in their dealings with Claimants concerning the Fund.

Ms. Pan's superiors also bore responsibility, of course, for supervising her performance and that of her sales colleagues. Respondent's supervision of Ms. Pan in the discharge of the duties she owed to

Claimants, insofar as shown in Respondent's evidence, was for all practical purposes non-existent. There was, for example, no showing whatsoever either of any significant oversight of Ms. Pan's contacts with Claimants in this respect, nor of any after-the-fact monitoring of the impact of her work on Claimants' understanding of the product that she had sold them. The contacts between Ms. Pan's superiors and Claimants, as these were shown in evidence, smacked more of "customer satisfaction" surveys than of any serious attempt by Respondent to insure that, through Ms. Pan, Claimants had been given the full understanding of the Fund to which they were entitled.

D. Respondent made, and suffered its agent to make, recommendations of an investment, namely the Fund, that was entirely unsuitable for Claimants in light of their investment history, objectives and risk tolerance.

It is not disputed that Respondent's agent Sandra Pan, when completing an internal form required to qualify the client to invest in the Fund and describing the investment objective of Claimants, wrote the word "preservation." Ms. Pan testified that, in using that word, she had intended to refer to preservation of capital. Ms. Pan went on to testify that she had erred in making that entry and that she had intended to write instead the word "conservative." The Panel finds that testimony not to be credible and finds that Claimants' investment objective was in fact preservation of capital.

John Knox, Respondent's senior official in charge of managing and directing the Fund, testified that the Fund was not designed or sold to achieve a preservation of capital objective or to meet the objective of "risk-averse" investors. Likewise, the language of the PPM referred repeatedly to the risk to which an investment in the Fund would be exposed. Again no doubt reflecting the serious deficiencies in Ms. Pan's training relating to the Fund, the outcome, it is clear, was that Ms. Pan recommended to Claimants an investment not in any way consistent with their investment objective. Far from preserving capital, that investment, of course, was responsible for Claimants' abrupt loss of 70 per cent of the value of their investment.

As noted, Ms. Pan's training relating to the Fund left her substantially without the tools that might

have enabled her to assess its suitability for Claimants or to warn them effectively of the risk that it posed to their capital. Yet with Respondent's consent and encouragement, she was left to suggest the Fund to Claimants as an appropriate investment for them.

It is possible that an investment in the Fund might have been suitable—or at least that it might have been made suitable—for Claimants, since Claimants are intelligent and experienced, not to mention independent-minded, investors. But Claimants were entitled to receive—and should have been required by Respondent to receive—an expansive and thoroughgoing explanation of the Fund from agents of Respondent who were fully trained and highly skilled in communicating about complex investments before being permitted to invest in the Fund—an investment product of a type and complexity that, broad as their experience was, Claimants were never shown to have ever encountered before. What Respondent offered Claimants by way of education about the Fund as an investment vehicle, as established in the evidence, was fleeting and slapdash. An investment in a highly complex and concededly risky product like the Fund, sold in this fashion, is by definition unsuitable for any investor with Claimants' investment history and characteristics.

E. Respondent's warnings concerning the risks inherent in an investment in the Fund indeed had a dramatic ring, but without more they were destined to be—as they proved to be—ineffectual.

Respondent's case put its most significant emphasis upon the written warnings of exposure to risk communicated to Claimants in the documents furnished to them prior to their purchase of the Fund, particularly in the PPM. Had Claimants actually reviewed these materials in full detail, sufficient to understand the nature and scope of the risks associated with investment in the Fund, they certainly could have been brought to an adequate understanding of the possible consequences of such an investment. That, however, did not happen. Hasty and imprecise conversations and sketchy and potentially ambiguous e-mail exchanges were far from enough to accomplish that result—a result that Respondent was duty bound to achieve. A free-standing doomsday warning unrelated in any adequate way to the

actualities of the Fund—much less the mere use of such terms as "risk" and "leverage"—does not suffice to discharge Respondent's obligations to insure that its customer is actually apprised of the suitability and risk of investments offered to them by Respondent.

None of this is to suggest that Claimants were uninformed or naïve investors. Professor Levinthal was shown by the evidence to have been on many occasions far too willing to accept representations that a person of his background, intelligence, education and position should certainly have inquired into more carefully. Among other things, as noted, he had a full opportunity to read the warning-laden offering materials relating to the Fund presented by Respondent.

The entire thrust of modern securities law, however, as it relates to dealings between industry professionals and their retail customers, stands against the notion of equality of responsibilities on both sides of that relationship. An investor may put his or her head in the sand, but only after the professional has done everything within reason to bring to the investor a full, fair and balanced understanding. Here the catalog of opportunities missed or omitted for bringing such an understanding to the investor is far too full to meet that standard.

F. Respondent's responsible agents failed to keep Claimants informed timely and accurately of significant adverse events in the life of the Fund of which Respondent was fully aware, about which Claimants could only have learned otherwise by making essentially random inquiry.

Respondent in effect withheld from Claimants information readily available to it concerning disturbing aspects of the Fund's performance that occurred during the fourth quarter of 2007 and in the first months of 2008. This information was of course fully known to Respondent's agents who dealt with the Fund, and who knew—and knew how to reach—the investors. It is true, of course, that the Fund documents obliged its managers to report to its investors only quarterly, and that they did. On the other hand, the reassuring tenor of those reports was hardly designed to encourage further inquiry by investors—quite the opposite. In this case, co-trustee Professor Levinthal did inquire directly, on

January 9, 2008, how the Fund was doing. Respondent's agents well knew at the time of that inquiry that the net asset value of the Fund was down significantly. In those circumstances, Respondent's response to Professor Levinthal to the effect that the Fund had performed well was misleading and inadequate.

Of course, investors who were not sufficiently inquisitive were most unlikely to smoke out and seize upon the periodic opportunities that the multiple pages of fine print in the Fund documents may have afforded to withdraw the current value of their investment from the Fund. The fee schedule collectible by Respondent was heavily top-loaded in favor of Respondent, giving Respondent and its agents a considerable incentive to try to profit by discouraging investors from withdrawing from the Fund—the very thing that, as Chief Judge (later Justice) Benjamin Cardozo famously said, in the leading New York case of *Meinhard v. Salmon,* fiduciaries are forbidden to do:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

249 N.Y. 458, 464, 164 N.E. 545 (1928).

3. Legal Theories under Which Claimants Prevail.

The Panel finds that each of the factual claims listed under numbered Paragraph 2., above, constitutes professional negligence, namely: failure to conduct proper due diligence in designing the Fund; failure properly to train its sales agents including Ms. Pan to sell the Fund to Claimants; failure adequately to supervise Ms. Pan in her selling of the Fund to Claimants; causing or suffering its sales agents including Ms. Pan, in their dealings with Claimants, to recommend to them an investment unsuitable for them; failure to deliver effectively to Claimants detailed, accurate, intelligible warnings concerning not only the facts of the risk of the Fund but also the scope, character and locus of that risk; and failure to keep Claimants timely and accurately informed concerning the progress of the Fund or lack thereof. Had

Respondent performed with due care in each of these circumstances, the Fund would not have been recommended to Claimants as a suitable investment for them; or, had they invested in the Fund contrary to a recommendation from Respondent, Claimants would have had accurate information concerning the Fund timely enough to enable them to withdraw before incurring the massive losses that they in fact sustained.

Each entry on the foregoing list of factual circumstances is likewise one as to which Respondent breached the fiduciary duty it owed Claimants with respect to Claimants' investment in the Fund. In each instance—in skimping on its due diligence in its design of the Fund; in conducting inadequate training of its sales representatives; in recommending to Claimants an unsuitable investment from which Respondent stood to profit; in failing to provide adequate supervision of its sales agents; in providing inadequate and incomplete warnings of risk to Claimants; and in failing to keep Claimants timely advised concerning the progress of the Fund—Respondent served its own interest in preference to those of Claimants by saving the money that could and should have been devoted to improving the product and its agents' understanding and servicing of it; making the product easier to sell by cutting corners in design and in devising and delivering inadequate risk warnings; as noted, acting to discourage investors from withdrawing from the Fund in aid of Respondent's interests when disinvesting would have in fact have afforded the investors, including Claimants, an opportunity that was in fact denied them to serve their financial interest; and perhaps in other ways.

3. Respondent's Claim for Indemnity Denied.

The Panel having determined that the damages suffered by Claimants were caused by the misconduct of Respondent in its dealings with Claimants in connection with the Fund, Respondent is not entitled to claim indemnity from Claimants for the costs to it of such damages. Accordingly, Respondent's claim for indemnity against Claimants is denied.

DAMAGES AND OTHER RELIEF AWARDED

After full consideration of all of the proofs and submissions of the parties, and of its findings based thereon, the Panel adjudges, determines and awards that Claimants **ELLIOTT C. LEVINTHAL, RHODA L. LEVINTHAL** and **THE ELLIOTT C. AND RHODA L. LEVINTHAL REVOCABLE TRUST DATED 10/09/80** shall recover the sum of **$2,100,000.00** by way of compensatory damages, which sum shall be paid to the aforesaid Claimants by Respondent **FIRST REPUBLIC SECURITIES COMPANY, LLC** within fifteen (15) days of the date of this Award.

The Panel further adjudges, determines and awards that the administrative filing and case service fees of the AAA, totaling $11,250.00, shall be borne entirely by **FIRST REPUBLIC SECURITIES COMPANY, LLC.** The other administrative fees of the AAA, totaling $2,200.00, shall be borne entirely by **FIRST REPUBLIC SECURITIES COMPANY, LLC.** The fees and expenses of the arbitrators, totaling $131,606.62, shall be borne entirely by **FIRST REPUBLIC SECURITIES COMPANY, LLC.** Therefore, **FIRST REPUBLIC SECURITIES COMPANY, LLC** shall reimburse **ELLIOT C. LEVINTHAL, RHODA L. LEVINTHAL and THE ELLIOTT C. AND RHODA L. LEVINTHAL REVOCABLE TRUST DATED 10/09/80** the sum of $78,153.32, representing that portion of said fees and expenses in excess of the apportioned costs previously incurred by **ELLIOT C. LEVINTHAL, RHODA L. LEVINTHAL and THE ELLIOTT C. AND RHODA L. LEVINTHAL REVOCABLE TRUST DATED 10/09/80** within fifteen (15) days of the date of this Award.

Accordingly, in summary, Claimants **ELLIOTT C. LEVINTHAL, RHODA L. LEVINTHAL** and **THE ELLIOTT C. AND RHODA L. LEVINTHAL REVOCABLE TRUST DATED 10/09/80** shall recover in this proceeding the grand total sum of **$2,178,153.32**, which sum shall be paid to the aforesaid Claimants by Respondent **FIRST REPUBLIC SECURITIES COMPANY, LLC** within fifteen (15) days of the date of this Award.

DISPOSITION OF STATUTORY CLAIMS

As noted above, Claimants' proofs having failed to establish the elements necessary to entitle them or any of them to recover their attorneys' fees under the the Elder Abuse Act, Claimant's claim for such fees under that Act is hereby denied.

Likewise, Claimants' claims under the California Corporations Code Section 25401, sounding in misrepresentation, and Sections 25235 and 25238, sounding in fraud and deceit, are hereby denied.

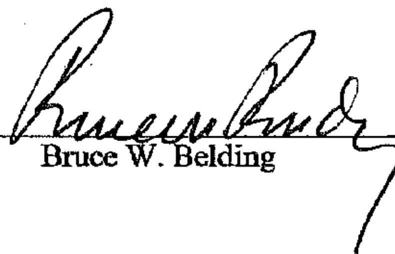
No other statutory claims have been submitted to the Panel in this case.

OTHER CLAIMS AND ISSUES RESOLVED IN THIS PROCEEDING

All other claims made in this proceeding not expressly granted or denied in the foregoing Award are hereby denied. No other issues were submitted, nor have any such other issues been resolved, in this proceeding.

This Award may be executed in any number of counterparts, each of which shall be deemed an original, and all of which shall constitute together one and the same instrument.

Dated: July 2, 2010



Bruce W. Belding

D. Steven Blake

Francis O. Spalding, Chair

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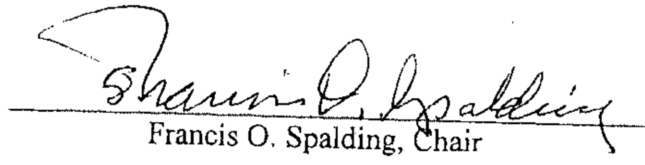
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