

CHAPTER 5

CASE EVALUATION

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§ 5-1 Introduction — Breach of Trust

Because any form of adjudication is time consuming, aggravating and costly, counsel should make every effort to settle a dispute of merit once he or she determines that there actually is a dispute that would justify filing a claim.

Every case of merit has a settlement value. If the participants in the settlement discussions have a firm handle on the facts and can objectively evaluate the strengths and weaknesses of their respective cases, a case can be settled and the broker-client relationship can be preserved. Too often, positions harden before the parties can properly assess the merits of a case, making settlement much more difficult. This chapter will assist parties at an early stage in the controversy. It will also help customer attorneys decide whether to take a case or to tell the customer that there is no chance of success.

It can safely be said that in the securities arbitration field, the primary claim made by most customers is that their trust in the broker was violated. Typically, for whatever reason, the customer was led to believe the representations of the broker and, in the process, suffered financial losses. What distinguishes a case of merit from a lost cause is whether the establishment of that trust relationship was well-founded or whether the customer should have known his trust had been misplaced. Situations where the customer understood or could have understood the risks of an investment or investment strategy, either through past experience or innate ability, usually results in a dismissal of the claim or greatly reduced damages. In such situations, the question is: Was it reasonable for the customer to rely on the representations of the broker?

Many potential customer claimants are stymied by confusion and strong emotional feelings. This can inhibit them from conferring with a securities arbitration attorney. “A widespread belief seems to exist that if one loses money

in connection with the stock market, there is never any legal recourse. . . . Illegal practices such as unsuitable investment recommendations, churning and misrepresentations tend to be hard for people to understand.”

Embarrassment and betrayal are two common emotions which customers experience when they begin to suspect they have been wronged by their stock broker. Embarrassment comes from clients feeling they are somehow at fault: “How could I be so stupid?” Feelings of betrayal come from the trust placed in the broker: “How could she do this to me when I trusted her so much?” Like other victims of fraud, both of these emotions keep many people from moving forward to assert their rights even when they know they have been wronged.¹

Trust established and trust breached is the common characteristic of most cases. How do brokers establish and cultivate trusting relationships with their customers? Why do investors succumb? Brokers have been known to deal with their customers in a certain manner to establish trust and to maintain the trust relationship. Appreciating those characteristics can enable customer attorneys and defense attorneys to see if, in the particular case before them, trust was established and then betrayed.

1. Establishing Trust

To induce customers into opening accounts, some brokers clothe themselves in the respectability and reputation of their firms. They show potential clients the monthly statements or other reports of their existing clients — the successful ones — and tell the potential client that, some day, they can be just as successful.

2. Creating a Need for the Broker’s Services

Brokers sow anxiety and discontentment in clients’ minds by insinuating that they can do better than their colleagues in order to make the customer dependent on them. This often happens when a broker leaves his or her firm and the branch manager rapidly divides up the departing broker’s accounts before the departing broker can transfer those accounts to the new firm. The new broker who has just been assigned the account will tell the customer how surprised he is with the account’s past performance, compared to how his own clients fared during the same period.

3. Exploit Customer Insecurities and Make Them Listen

Everyone invests to make a profit of some kind or to generate a greater return than keeping their money in the bank. Some brokers stress the profit potential of a security and lose sight of — or purposely fail to disclose — the risks involved. With a falling stock market, they tell their customers of “cycles” and the need to

¹ Jerome E. LaBarre, *Securities Case Development at the Early Stage*, in *Securities Arbitration 1998* (Practising Law Institute).

invest at the market's low. This, they say, is the best time to invest, when the market is at its lowest. It can only go up, they say. You have the greatest opportunity, they add, when everyone else is selling, to "grab bargains." In a volatile stock market, customers are so unsure about investing that some brokers take advantage of this insecurity and mislead their customers with unreasonable expectations.

As commission-driven individuals, the average broker does not make money if his customers do not engage in transactions. Therefore, in difficult markets, they lure the unsuspecting and overly-trusting customer by dealing with that customer's primary insecurities and desire to make money. This technique is sometimes used on customers whose accounts have suffered great losses with another broker. The customer is vulnerable and will often go beyond his normal risk tolerance to "make it back." Appealing to that need, some brokers will promise more than they can deliver.

4. Keeping the Customer

In a scenario where a new broker has taken over the account, he or she convinces the customer to sell most of what the prior broker recommended for the portfolio, as part of the new broker's strategy for success. What happens when the performance of the new strategy is not as promised? To keep the customer, the broker will blame the "unpredictable market" and will recommend yet another strategy, never attributing poor account performance to the broker's own failed strategy.

The subject of "trust established and trust breached" was examined by Donald C. Langevoort, in a *California Law Review* article, "Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers" (84 Cal. L.Rev. 627, 1996), written before the burst of the stock market bubble in 2000. Because most transactions between customers and brokers are based on oral, as opposed to written, representations, there is an inherent conflict between the rendition of events, both self-serving. Because of this conflict, arbitrators tend to focus on motive and opportunity. That is:

The customer's case emphasizes the broker's motive in gaining commission or mark-up profits by misstating or concealing risk, or promising inflated returns. The plaintiff usually portrays opportunity as the abuse of the trust and reputation that brokers are trained to cultivate so carefully.

The broker's lawyer will likely respond with a powerful list of behavioral assertions predictable to those versed in law and economics:

- (1) A broker's dominating interest is in developing long-term customer relationships in order to generate repeat business in a highly competitive market;
- (2) For this reason, neither individual brokers nor their firms systemati-

cally cheat their customers, because the threat of loss of business that would follow from customer dissatisfaction would deprive them of far more future income than the single cheating opportunity would offer;

- (3) It is irrational even to try to misrepresent or conceal risks from a sophisticated customer. Since these customers are generally familiar with investment risk-return relationships, they can readily detect such cheating and terminate the relationship;
- (4) Therefore, the broker's story of sufficient candor is the more credible one. . .

The customer's lawyer will counter with a simple question: If all this is so, why are there so many notorious examples of broker cheating?

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Taking Responsibility versus Blaming Others

Taking responsibility is the balance point of securities arbitration and mediation. The reality, in customer-broker relationships, is that parties have definable responsibilities. Arbitrators often find those responsibilities obscured when confronted with "the blame game", which goes something like this:

- *Customers blaming brokers and firms* is often the result of customers' laziness to learn how their money was to be invested and to keep abreast of the performance of the investments (either through frequent contact with the broker or by reading trade confirmations and monthly account statements).
- *Brokers blaming customers* by arguing that the latter ratified the alleged misconduct or failed to mitigate damages sooner, is a defense strategy utilized to avoid responsibility for the problematic conduct of brokers and their firms.

- *Brokers blaming their firms* for not providing adequate due diligence or pushing particular products or money managers is counterbalanced by *firms blaming their brokers* for not reading unreadable compliance manuals or for not knowing that the complaining customers were less than forthcoming - about their net worth, investment experience and investment objective.
- *Parties blaming the NASD and NYSE Staff*: (1) for proposing or selecting arbitrators whose records disclose a pattern of decisions strictly for one side or another and (2) for an arbitrator's failure to take seriously the responsibilities inherent in being a conscientious and fair arbitrator.
- *Parties blaming arbitrators*: (1) who are unprepared for pre-hearing conferences, pre-hearing motion practice, pre-hearing communication with the parties and full-day attendance at arbitration hearings, (2) who fail to keep an open mind while hearing the case and who decide cases on preconceptions and biases and not on the evidence presented, and, (3) who render irrational decisions.
- *Parties blaming their attorneys* for not having the ability or desire to tell clients the weaknesses of their cases, necessitating the hiring of expensive professional mediators to do the attorneys' jobs.
- *Customer attorneys blaming mediators* for not getting them a better settlement because, they believe, of an unspoken desire by the mediator for future business from that brokerage firm.
- *Attorneys blaming attorneys* for frivolous motion practice, for intentional discovery deficiencies and for an unwillingness to commit to the expeditious resolution of the case.

It always seems to be *the other guy* who should be responsible, from the initial decision to make an investment to the reaction on receiving an adverse arbitration Award. However, in the end, the Award should be a reflection of responsibilities, an apportionment of obligations, actions and inactions. In "Establishing a Reasonable Standard of Responsibility for Broker-Customer Relationships" (PLI's *Securities Arbitration 2006*), Texas customer attorney Jeanne Crandall wrote that customers should not be held responsible for acts which are within their brokers' duty of care. However, she added, a customer cannot ignore the information available to him or hold the broker responsible for damages which the customer could have avoided. What duties are owed by brokers and what are the standards of responsibility for customers?

1. *The Principles of Agency Law Apply to Determine Broker Responsibility*
- Most courts have held that a broker is an agent for his customer and that

the broker owes the duties of a fiduciary for all matters within the scope
(Text continued on page 5-7)

