

# INVESTING



## *in* LOUISIANA

# A Bull Market for Investor Claims

## Disputes Between Customers and Brokers/Brokerage Firms

By John C. Anjier and George Denègre, Jr.

**I**n the wake of today's bear market, brokerage customers in large numbers have turned against their former financial advisors in an effort to recover some of their trading losses.<sup>1</sup> As *Newsweek* recently put it, "the bear market for stocks has produced a bull market in complaints against brokers."<sup>2</sup> For this reason, it is more likely than ever that Louisiana lawyers will be involved in securities arbitration. This article outlines the primary remedies available to the aggrieved investor and describes the basics of the securities arbitration process.<sup>3</sup>

### Potential Causes of Action

Customer claims against brokers have developed into a specialized area of law with its own terminology, causes of action and procedures. Potential causes of action derive from federal law, primarily the anti-fraud provisions of the Securities Exchange Act of 1934,<sup>4</sup> state Blue Sky (secu-

rities) law,<sup>5</sup> as well as duties imposed under the Louisiana Civil Code and common law. Some claims, such as unsuitability, may be raised as a federal claim (Rule 10b-5), a state Blue Sky law claim or as a state law claim like fraud, breach of fiduciary duty or negligence. The form of a claim is important because different claims differ in prescriptive periods, intent requirements and damages available.

### Misrepresentation/Fraud

A documented claim of misrepresentation is often the easiest claim for a claimant to pursue. Misrepresentation claims can be brought as traditional securities fraud claims, state law claims or both. Arbitration panels often determine cases based on equitable factors. If a claimant can prove that the broker misrepresented any material fact or omitted material information in selling a security, it is likely that the arbitration panel will look unfavorably upon the broker.<sup>6</sup> Of course, as in any

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fraud-based claim, causation and reliance must be proven.<sup>7</sup>

If the claim is based on oral misrepresentations, a common and effective defense is that the written materials provided to the customer contradicted the oral misrepresentations.<sup>8</sup> For example, a claim may allege that broker told client that the mutual fund earns at least 7 percent every year. However, the written prospectus provided to the client explained that returns would vary and the investment was subject to market risks. In such situations, an arbitration panel may find that the client's reliance on the oral misrepresentation was not reasonable. On the other hand, if disclosure is buried in a lengthy prospectus, the arbitrators may make short shrift of this defense.

### **Unsuitability**

Another common cause of action is based on a broker's unsuitable recommendation of a security. This type of claim is based on duties imposed by the National Association of Securities Dealers, Inc. (NASD), the regulatory body for broker-dealers, and the New York Stock Exchange (NYSE).<sup>9</sup> There is no independent cause of action for unsuitability.<sup>10</sup> Instead, the claim must be asserted under Rule 10b-5 or state law and is premised on violation of the broker's suitability obligations.<sup>11</sup> Significantly, suitability duties only apply to transactions in which the broker *recommends* the purchase or sale of a security. A broker who merely fills a customer's order is not under the same duty.

Generally, under the suitability rules, the broker must be familiar with the customer's financial situation and needs and the broker must have "reasonable grounds for believing that the recommendation is suitable."<sup>12</sup> Moreover, the broker must exercise due diligence, *i.e.*, have a reasonable basis for recommending the security. For example, if a client indicated her investment preferences were moderate growth and safety of principal, but the broker recommended that she invest entirely in technology stocks, the client may have a valid unsuitability claim. Many situations are less obvious. In fact, some commentators have argued that a broker's failure to "recommend a diversified portfolio of stocks or other investments" should be a *per se* violation of the suitability rule.<sup>13</sup>

In all such cases, the customer's sophistication will be of great importance. The higher the sophistication level, the less the customer will be able to shift responsibility for the investment decision to the broker.<sup>14</sup>

### **Churning**

Churning, which is actually a variation of a suitability claim, occurs when a broker who controls a customer's account excessively buys and sells securities for the customer, without regard to the customer's interest, for the purpose of generating commissions.<sup>15</sup> Churning is typically brought pursuant to Rule 10b-5, but also can be pursued as a state law claim. One test finds broker-control "when the client routinely follows the recommendations of the broker."<sup>16</sup> This claim will often involve detailed analysis on the frequency of trades and the amount of commissions generated by the broker.

### **Breach of Fiduciary Duty**

Under Louisiana law, a securities broker owes a fiduciary duty to his clients.<sup>17</sup> To establish a breach of fiduciary duty, the claimant will be required to show "fraud, breach of trust, or an action outside the limits of the fiduciary's authority."<sup>18</sup> As with most securities claims, the broker's duty will decrease as the customer's sophistication increases.<sup>19</sup> A variety of securities claims can be framed as a breach of fiduciary duty. Traditional breach of fiduciary duty claims give the claimant a much longer prescriptive period to bring the claim — specifically, 10 years versus one year for fraud. However, in many instances, breach of fiduciary duty claims are deemed to be fraud claims, thus rendering breach of fiduciary duty claims more difficult to prove than other state law claims and resulting in the application of the one-year prescriptive period.<sup>20</sup>

### **Negligence**

Traditionally, securities lawyers looked at securities claims as variations of fraud claims with a lesser level of intent required. However, it can be difficult to satisfy all of the elements of a traditional securities law fraud claim and numerous defenses are available. For this reason, plaintiffs are starting to recognize that many claims against brokers can more easily be brought by simply asserting negligence.<sup>21</sup> To establish a claim for negligence, the customer must show that the broker breached a duty owed by a reasonable broker under the circumstances. There is substantial disagreement as to what duties a broker owes to his customer and the duties will vary depending on the customer and the particular relationship between the broker and the customer.<sup>22</sup>

### **Unauthorized Trading**

Unauthorized trading occurs where trades

are executed in a customer's account without first obtaining specific prior approval, either by written discretionary authority granted to the broker or by oral 'time and price' discretion.<sup>23</sup>

It may be pursued as a Rule 10b-5 action or as a state law claim like breach of contract or breach of fiduciary duty.<sup>24</sup>

### **Failure to Supervise and Vicarious Liability**

The brokerage firm may be liable directly or under various vicarious liability (respondent superior) theories. An important direct claim against firms is a claim of failure to supervise. Brokerage firms are required to adopt and enforce adequate procedures to ensure compliance with industry rules, regulations and standards.<sup>25</sup> If the firm does not establish adequate procedures or adhere to them, it may be liable for failure to supervise.<sup>26</sup>

Vicarious liability theories are available under federal and state law. Under federal securities laws, "controlling persons" of the broker can be liable. Liability is not absolute and it is a defense if the controlling person did not directly or indirectly induce the wrongful acts and acted in good faith.<sup>27</sup> Under Louisiana law, the firm generally will be responsible for the conduct of its brokers as long as the brokers' acts were within the course and scope of their duties.<sup>28</sup>

### **The Securities Arbitration Process**

If you are bringing a claim against a broker and/or his firm, or are defending a claim, in all likelihood, you will be participating in securities arbitration. In the wake of a series of United States Supreme Court cases enforcing pre-dispute arbitration clauses, most brokerage firms generally include pre-dispute arbitration clauses in customer agreements. While there are some grounds for avoiding arbitration, courts favor arbitration and generally enforce pre-dispute arbitration agreements in brokerage contracts.<sup>29</sup>

Our experience is that securities arbitration is an excellent forum for claimants and respondents. Arbitration is almost always faster and less expensive than litigation, due primarily to limited discovery and motion practice.<sup>30</sup> Most arbitrations are concluded in less than a year. Although the customer is likely to "have his day in court" — pre-hearing motions to dismiss are rarely granted — the arbitration panel is less likely than a jury to render an outsized damage award. In our view, although some disagree, arbitration is fair to cus-

tomers.<sup>31</sup> NASD statistics reflect that, from 1997-99, the customer was awarded money approximately 60 percent of the time.<sup>32</sup>

### **NASD Arbitration**

Most securities arbitration claims are now decided before NASD Dispute Resolution, Inc. (NASDADR) panels, a subsidiary of the NASD that handles arbitrations and mediations. NASDADR arbitration hearings are governed by their own Code of Arbitration Procedure, which can be retrieved from [www.nasdadr.com](http://www.nasdadr.com). The hearing location is normally the NASDADR office closest to the customer's residence at the time the dispute arose.<sup>33</sup> The arbitration panel will consist of either one or three arbitrators, depending on the amount in controversy.<sup>34</sup>

An action is commenced by filing a statement of claim with the NASDADR, along with the appropriate filing fees. Many practitioners prefer to use a narrative-letter format, with a detailed statement of the facts, rather than a formal pleading. Discovery in NASDADR arbitration is not as broad as it is in litigation. The parties may serve requests for documents and information.<sup>35</sup> Information requests are narrower than interrogatories and are limited to the identification of individuals, entities and time periods related to the dispute. The NASDADR has promulgated a Discovery Guide which includes several lists of presumptively discoverable documents.<sup>36</sup> Counsel should study these lists at the outset of discovery. Depositions are strongly discouraged in arbitration, although they are sometimes allowed to preserve testimony, to accommodate scheduling problems or to address unusual situations.<sup>37</sup>

The NASDADR hearing is similar to a bench trial, with opening and closing statements and direct and cross-examination of witnesses. However, the proceedings are less formal than a trial and the arbitrators are not bound by either the state or federal rules of evidence.<sup>38</sup> Our experience is that most credible evidence will be admitted.

Within 30 days after the hearing, the arbitration panel will enter its award.<sup>39</sup> Generally, the arbitrators do not render a written opinion, although the award contains a summary of the parties' allegations and defenses. An arbitration award is very difficult to overturn and can only be modified or vacated in instances of manifest disregard of the law, arbitrator misconduct or if the award was procured by corruption, fraud or undue means.<sup>40</sup>

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house counsel and contacts with expert witnesses and outside counsel with expertise in this area. A claimant's counsel who does not practice in this area can find himself overwhelmed by the intricacies and details of broker/dealer rules, regulations and industry standards. However, there are many sources of information (including the securities arbitration treatises cited here), and the NASDADR staff and published materials are very helpful. The filing fees and other costs of NASDADR proceedings are partially subsidized by member organizations. This cost-effectiveness, in tandem with streamlined claims procedures, make NASDADR arbitration a very workable conflict resolution mechanism.

#### FOOTNOTES

1. Investors are filing a case every 20 minutes with the NASD. Linda Stern, "The Claims Games," *Newsweek*, May 7, 2001, at 77. Suitability complaints to the SEC increased 58 percent. *Wall St. J.*, April 26, 2001, at C1.
2. Stern, *supra* note 1 at 77.
3. See generally, David E. Robbins, *Securities Arbitration Procedure Manual* (3d ed. 1998) (hereinafter Robbins); Marilyn B. Cane and Patricia A. Shub, *Securities Arbitration Law and Procedure* (BNA 1991) (hereinafter Cane and Shub).
4. 15 U.S.C. §§ 78a-78hh-1.
5. Louisiana's Blue Sky law is found at La. R.S. 51:701, *et seq.*
6. See generally, Robbins at 140-145; Cane and Shub at 119-139.
7. See, e.g., *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1119 (5 Cir. 1988), *judgment vacated on other grounds sub nom*, 492 U.S. 914, 109 S.Ct. 3236 (1989).
8. See, e.g., *Luce v. Edelstein*, 802 F.2d 49, 56 (2 Cir. 1986).
9. See NASD Conduct Rule 2310, NASD Manual (CCH) ¶ 2310 at 4261; New York Stock Exchange Rule 405. See generally, L. Lowenfels and A. Bromberg, "Suitability in Securities Transactions," 54 Bus. Law 1557 (1999).
10. See, e.g., *Craighead v. E.F. Hutton & Co.*,

- 899 F.2d 485, 493 (6 Cir. 1990).
11. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2 Cir. 1993).
12. NASD Conduct Rule 2310, NASD Manual (CCH) ¶ 2310 at 4261.
13. Richard A. Booth, "The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk," 54 Bus. Law 1599, 1601 (1999).
14. See *Creml v. Brown*, 955 F.Supp. 499 (D. Md. 1997).
15. *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5 Cir. 1987), *cert. denied*, 487 U.S. 1205 (1988).
16. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9 Cir. 1980).
17. *Romano*, 834 F.2d at 530; *Williams v. Edward D. Jones & Co.*, 556 So.2d 914, 916 (La. App. 3 Cir.), *cert. denied*, 559 So.2d 1367 (1990).
18. *Gerdes v. Estate of Cush*, 953 F.2d 201, 205 (5 Cir. 1992).
19. *Romano*, 834 F.2d at 530; *Beckstrom v. Parnell*, 97-1200 (La. App. 1 Cir. 11/6/98), 730 So.2d 942, 948.
20. See *Jolley v. Welch*, 904 F.2d 988, 995 (5 Cir. 1990), *cert. denied*, 498 U.S. 1050 (1991).
21. See, e.g., *De Kwiatkowski v. Bear Stearns & Co.*, 126 F.Supp. 2d 672 (S.D.N.Y. 2000).
22. *Id.*; *Williams*, 556 So.2d at 916.
23. Robbins, *supra*, at 135.
24. *Jaksich v. Thomson McKinnon Sec., Inc.*, 582 F.Supp 485, 493-95 (S.D.N.Y. 1984).
25. For a thorough analysis of broker/dealer supervisory obligations, see *In re Dean Witter Reynolds, Inc. and Dennis W. Peterson*, SEC Initial Decision Rel. No. 179 (Jan. 22, 2001).
26. See, e.g., *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817, 821 (6 Cir. 1981).
27. See 2 Harold S. Bloomenthal, *Securities Law Handbook* at 185-86 (West 2001).
28. La. Civ.C. art. 2320.
29. See, e.g., *Folkland v. Thomson McKinnon Sec., Inc.*, 484 So.2d 310 (La. App. 3 Cir. 1986).
30. Robbins, *supra*, at 2, 3.
31. *Id.* at 3.
32. *Id.* at 3 (3d ed. Supp. 1999).
33. NASD Uniform Form Guide at 11. New Orleans is the primary location for NASDADR hearings in Louisiana.
34. NASD *Code of Arbitration Procedure* Rule 10308(b).
35. NASD *Code of Arbitration Procedure* Rule 10321.
36. NASD Notice to Members 99-90.

37. *Id.*

38. NASD *Code of Arbitration Procedure* Rule 10323; *Bell Aerospace Co. v. Local 516, Int'l Union, United Automobile*, 500 F.2d 921, 923 (2 Cir. 1974).

39. NASD *Code of Arbitration Procedure* Rule 10330.

40. La. R.S. 9:4210; 9 U.S.C. § 10-11; *Antwine v. Prudential Bache Sec., Inc.*, 899 F.2d 410, 413 (5 Cir. 1990).

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