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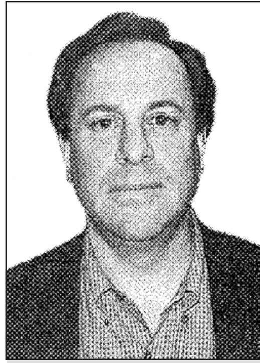
OUTSIDE COUNSEL

by Richard A. Roth

Why Some Brokerage Firms Are Now Suing Their Customer



Let the retail customer-claimant beware: The days of a broker staying on the defensive is over. Brokers are now aggressively bringing counterclaims against their litigious customers - as both a sword and a shield - to stave off a current wave of customer lawsuits and cause the customer to have exposure of his own. It has become commonplace that, when a customer loses money on an investment gone awry, he hedges his bet by suing his broker. What makes the litigious customer so willing to sue is that there is no downside. There is a plethora of claimants' attorneys - both good and bad - who take these cases on a contingency fee. That is, the customer lays out only minimal expenses, and the attorney takes all the risk. Thus, the downside to the customer in suing his broker is nearly nonexistent. The numbers prove the trend.

According to statistics released by the NASD in 1998 there were 4,938 arbitrations filed. In 1999, that number jumped to 5,608. The number continued to rise in 2000 to 5,558. The year 2001 saw 6,915 arbitrations and in 2002 that number again rose to 7,704. In 2003 that number further increased to 8,945. And through February of this year alone, 1,234 arbitrations have already been filed.

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Reasons to Sue

Brokerage firms are taking it on the chin no more. Instead, they are giving the customer risk, by suing him back. There are a myriad of bases upon which to sue a retail customer, including breach of contract, fraud in the inducement, breach of the obligation of good faith and fair dealing, defamation, malicious prosecution and other torts. One of the strongest of those counterclaims arises where the customer makes a material misrepresentation of fact to the brokerage firm upon which the firm relies, in other words, fraud. By way of example, in a suitability case - where the customer alleges that the investments were not suitable - the Broker has a right to rely on the information in the New Account Form executed by the customer. Where those statements as to net worth, liquidity, investment objective and risk exposure are wrong, and the customer confirms their accuracy, a fraud has taken place.

As common is the claim by a customer where he not only purchases securities but also enters into private transactions promoted by the brokerage firm. Over the course of their dealings, often a broker will bring certain private placements to the attention of the customer as a potential business opportunity. Ideally, this relationship of suggestions from the broker and assurances from the customer will yield positive results for all parties. However, in light of the dot-com bubble bust as well as the implosion of numerous private transactions, customers continue to sue their brokers not only for equities purchased and sold on the market, but for those private placement investments gone awry. However, with each private placement investment comes a series of representations, warranties and covenants from the customer. That is, under the SEC rules, customers execute, among other things, subscription agreements and investor questionnaires.

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Private Placement Memo

In those documents, customers confirm that they have read the Private Placement Memorandum (PPM), which is riddled with risk disclosures and actually warrant the following: (i) the customer is an accredited investor, meaning in essence, customer has had a certain minimum income for the past two years of over $1 million in net worth; (ii) the investment is a suitable one for the particular investor; (iii) the customer has investment experience; (iv) the customer understands that the investment involves substantial risk; (v) the customer is prepared to lose all of his investment; and (vi) the customer is not relying on any statements in making the investment other than those representations contained in the private placement memorandum. Those same agreements typically contain provisions by which the customer agrees to hold harmless and indemnify the broker, the brokerage firm, and placement agent for any breach of his representations. They also provide that the customer will pay the firm's legal fees.

Well, where a customer sues and makes allegations that directly contradict his representations, then he breached the subscription agreement, didn't he? Didn't he also make a material misrepresentation of fact upon which the firm relied in allowing him to invest? Didn't he state under oath that he was an accredited investor? Wasn't it the customer that represented that he was an experienced investor? Wasn't it the customer that represented that he will not sue the broker in the event he later loses in his game of "wheel of fortune"? And didn't the customer represent that he will reimburse the broker for expenses incurred if he is later forced to defend against any such claims?

The various counterclaims hold the customer accountable for his fraud, misconduct and breaches of contract. Indeed, all of these representations by the customer were relied upon by the firm in its decision to allow him to invest.

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This is exactly why brokers are now fed up with customers who were willing to roll the dice, but are now not willing to accept the consequences. Accordingly, counter-claims are now being used as a tool to expose the customers' heads-I-win-tails-you-lose philosophy.

With the agreement signed by the customer in hand, the broker can now file his counterclaims against the customer for breach of contract and fraud in the inducement. And some brokers are winning.

So in the arbitration, the customer now goes on the defensive and proceeds knowing that he may have to pay the firm. And panels are beginning to listen.

Fighting Back

Within the past few months, two arbitration panels - one in Boston and one in San Francisco - have awarded brokerage firm Adolph Komorsky Investments[1] money in similar actions.

In *Trade Advertisers v. Adolph Komorsky Investments*, a NASD panel not only threw out the customer's claims, but awarded the brokerage firm $50,000 in legal fees on such a counterclaim. The fees were sought, not based on any state law or contract provision, but because the brokerage firm argued that claimant's claims were frivolous. The panel agreed.

Only a few weeks later, the same brokerage firm, before a San Francisco panel, followed suit. In *Pun Man Chi v. Adolph Komorsky Investments*, the customer sought hundreds of thousands of dollars for claims including unsuitability, failure to follow instructions and unauthorized trading.

The panel rejected each and every claim. In so doing, it found the claims to be frivolous and awarded the brokerage firm $15,000 in costs and expenses.

There are other bases upon which brokerage firms are fighting back. By way of example, they are counter-claiming when the customer leaves the firm with a significant debt balance in the margin account. Those counterclaims are based on the margin agreement, which also provides for legal fees to the firm. Counterclaims for malicious prosecution, attorney's fees, defamation and other breaches of contract are also creeping up.

Not every case warrants a counterclaim. That little old lady claimant will be perceived as a victim and any frivolous counterclaim can be perceived by a panel as over-agressive tactics by the firm.

However, a word to the wise. Not every case warrants a counterclaim. That little old lady claimant will be perceived as a victim and any frivolous counterclaim can be perceived by a panel as additional over-aggressive tactics by the firm.

With that proviso, the customer cannot use a brokerage firm as both a securities firm and an insurance company to insure their losses. Such counterclaims can help expose these types of hypocrisies. As Judge Milton Pollack, of the United States District Court for the Southern District of New York recently held in a strongly worded opinion, customers should not be allowed to "twist the federal securities laws into a scheme of cost-free speculators' insurance."

According to Judge Pollack's decision, *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*, 2003 U.S. Dist. LEXIS 11005 (S.D.N.Y 2003), "plaintiffs would have this Court conclude that the ... securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful. … [P]laintiffs have lost fair and square."

Conclusion

It has been correctly argued that the litigation floodgates in England have yet to be opened because of the fact that in England the losing party pays the winning party's attorneys fees. While the United States is not likely to adopt England's winner-friendly philosophy anytime soon, the increasing number of counterclaims brought in broker arbitrations, combined with the recent arbitration and court decisions, may just make the litigious customer take pause before filing suit.

1. The Roth Law Firm represents Adolph Komorsky Investments.