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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

September 1999 Volume 6 Number 3

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The

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Editor's Notes

This issue of the *Quarterly* contains Return to Basics III: Duty to Mitigate Damages in "From the Professor" by Joseph C. Long. Also included is an article by Seth E. Lipner entitled, "Mediation From the Perspective of Claimant's Counsel: Not Whether, But *When* to Mediate."

The deadline for receiving submissions for the December, 1999 issue of the *Quarterly* is December 10, 1999. All submissions, regardless of length, should be accompanied by a computer disk of the submitted materials in either word perfect or as a text file.

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Letter From the President

Mark E. Maddox, MADDOX KOELLER HARGETT & CARUSO, Indianapolis, IN

Dear Friends:

As I tum the reigns of PIABA over to Jim Beckley, it amazes me as to how much we've accomplished this past year. The NASD's proposed punitive cap rule seems to be going nowhere at the SEC. The new discovery guide is about

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to take effect, which should either reduce or make easier discovery disputes for investors. The NASD is once again studying its case intake system, and I expect more improvements to either reduce or eliminate the dreaded deficiency letters which back up and delay our cases.

In the past year, PIABA has raised its profile with the media, Congress, and the SEC. We've been on the forefront informing Congress about problems with SIPC, and also unpaid arbitration awards. The GAO is currently conducting a survey about unpaid awards in 1998. Please respond ASAP. SIPC reform is a new concept to this Congress, and it may take a few years (and possibly a new Congress) before the issue moves forward.

On the home front, PIABA membership is at an all-time high. The program for the Annual Meeting is as good as ever, with record attendance expected. PIABA committees functioned as well as ever, and are grooming the next generation of our leadership. Technology is being used by our members to communicate with each other in unprecedented ways, giving us an edge over our adversaries. Finally, Robin Ringo continues to be the glue that holds us all together and pushes us onto new levels. Much was accomplished, but much is left to do. Please give Jim Beckley and his Board the same level of support you gave to me and our Board this past year. Thanks for the privilege of serving you this past year.

Sincerely,

Mark Maddox
PIABA President

MEDIATION FROM THE PERSPECTIVE OF CLAIMANT'S COUNSEL: NOT WHETHER, BUT *WHEN*, TO MEDIATE

By: Seth E. Lipner, Esq.
DEUTSCH & LIPNER, Garden City, N.Y.

Much has been written and said about the types of cases which work best in mediation; about selecting a mediator; about which mediator style works best in which cases. Some, but not enough, has been written and said about how to be a good advocate and negotiator in mediation. Even less has been written and said, however, about how an investor's attorney can utilize this method of dispute resolution to the optimal benefit of the client and the attorney.

The benefit both client and attorney receive from mediation are several fold: with mediation, negotiations are less chaotic, more efficient and less stressful. Without mediation, efficient negotiation is hindered by, inter alia, problems of phone tag, repetitive conversations, and agonizing ruminations. Of course, this is not to say that participating in a mediation is stress-free - the stress is, however, compacted into a single day (or two at most), rather than extending over broad swaths of time. The client benefits from the reduced stress; the attorney benefits from the increased efficiency.

With mediation, it is easier to be confident that no significant money was left on the table. The face-to-face style, combined with a hard-working mediator, usually provide a measure of confidence that, from a financial standpoint, the final offer was the highest that was available. The client benefits financially; the attorney benefits because he is more likely to have a client who is happy, in the long-term, with the result.

In cases which don't settle, client and attorney have gone through the case in the presence of the adversary and a neutral - a good learning experience for both.

In order for an investor and attorney to take optimum advantage of these benefits, the attorney should consider a critical question: when is the best moment to mediate? Is it early in the case, after the basic facts are gathered, but before extensive discovery? Or is it right before the hearing, when all the work has been done and the case is ready for hearing?

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This author's belief is that the best time to mediate, *i.e.* the time when attorney and client can gain maximum utility from the process, is fairly late in the game, if not right before the hearing. Certainly, the best time is after all discovery is complete and the case is ready to go. Early mediation may produce a settlement and some cost savings, but, for the reasons offered here, it is less likely to achieve the best overall result, both financial and emotional.

The reasons for preferring to mediate late can be summarized as follows: (a) it gives the attorney a chance to get to know the client, to get to know the case, and to get to know the adversary; (b) it gives the client a chance to get to know and have confidence in the attorney, and it helps the client better understand the strengths and weaknesses of the case; and (c) it gives the brokerage attorney a chance to get to know the case, and the weaknesses of his client, and it gives that attorney a chance to get busy with other things. None of these goals can be accomplished in an early mediation. Each of these three reasons for "mediating late" is discussed ***seriatim***.

Getting to Know the Case, the Client and the Adversary

An attorney does a disservice to the client if he advises a client to settle or not settle at a time when the attorney is not in possession of all the facts. At the early stages of a securities case, one thing is virtually certain - the broker knows more about the investor than the investor knows about the broker. The situation can be likened to playing 7-card stud poker against an opponent playing 5-card draw. The 7-card player may have the better hand, but the 5-card player's hand is closed, so he is likely to want to fold (***read*** settle) if his hand is a bust compared to what he can see in the 7-card player's hand. In the betting (***read*** negotiations), the player (***read*** broker's lawyer) with the closed hand has all the advantage. Not a good place to be if you are the investor, or the investor's lawyer. In order for the attorney to best advise the client, he needs to see as many cards as he can.

When a client engages an attorney, he is seeking not only an advocate, but also an advisor. In order for the attorney to have done his job, he must not only obtain all the information which is obtainable, he must decide how to use it to maximum advantage. Anything less, and the attorney is being neither a good advocate nor a good advisor. The attorney who opts for early mediation has not done his job.

The need to obtain all the information is important not only to the attorney who must advise, but also to the client. First, the client wants that information to make an informed decision. But obtaining the information also insures that the client will be confident, months later, that the settlement was not made prematurely. Imagine if, six months after a settlement, a client learned about an important negative fact about the broker which the attorney did not discover in apparent haste to procure a quick settlement. Not a good situation for both attorney and client.

So, at a minimum, full discovery must take place before any mediation. But even at that stage, more work needs to be done to be ready to mediate. Knowing the case isn't just about discovery. It involves getting to know, and thinking about, the case's strengths and weaknesses, about how certain "spins" on bad facts will work, about how to best pound on the good facts, about the best expert, the best order of witnesses, the best theories, and the pitfalls to avoid. In this regard, building a winning case is a little like making rice - it takes 20 minutes on simmer; you can't make good rice by turning the heat up to high, then cooking for only 10 minutes.

A mediation session can be instructive and educational, but to be effective that way, it must done late, because only then is the attorney fully prepared to put on his best case. And, at that point, the client is in the best position to learn to be an effective witness, and to answer questions about the case in a stressful setting. Early mediation, by definition, precludes such an education, and such an experience for client and counsel, precisely because it is too early.

Late mediation also gives the attorney a better opportunity to know the client. The attorney will not only have greater opportunity to gain the client's trust, he will get see how the client reacts to the professional relationship, he will get to know the client's emotions, the level of intelligence and the amount of perspective the client has. In some cases, the attorney will know whether this client ***needs*** to settle, ***e.g.*** because the client can't go through with (or win) a trial; in others, the attorney will decide that this is a case worth taking to trial. Getting to know the client is important to learning about strengths, weaknesses and needs, things that are never sufficiently known in the early stages of a case.

The attorney can also benefit from learning about the adversary. Whether dealing with outside counsel or in-house counsel, the investor's attorney is not dealing with the ultimate decision-maker. Getting to that decision-maker is important, whether it is done directly or indirectly, ***i.e.*** through the attorney. When a case is about to go to hearing, the key people will have been identified, they will have been educated about the case, and they will be focused on what is going on. At an early stage, there can be no assurance that any of that has taken place.

As a case progresses, an experienced attorney will take every opportunity to listen to his adversary, in order to learn that person's perception of the case's strengths and weaknesses. The investor attorney can then spend his time and effort working toward addressing (and, it is hoped changing) those perceptions.

Late mediation also provides an opportunity to build a relationship of respect, so that the brokerage attorney will be more effective in trying to convince the firm to put more and more money on the table.

All these factors augur in favor of late, rather than early, mediation. By waiting and doing a good job of lawyering, an attorney adds value to the case, not just economic value, but emotional value as well. Getting to know the case, the client and adversary is essential to good lawyering.

Giving the Client a Chance To Get To Know the Attorney, and To Better Understand the Strengths and Weaknesses of the Case

Giving the client an opportunity to get to know the attorney is essential to establishing trust. Our investment clients are strangers when they come to us, the product of referral, or advertising, or other word of mouth. By definition, the client's trust has already been violated by one set of professionals (the broker and brokerage firm); under these circumstances, trust between client and attorney will not be established overnight. That trust will be crucial in a successful mediation, not only so that the client will not think he is being "sold out", but also so that the attorney will have maximum influence at the mediation, when the recommendation to settle will (or will not) be made. And importantly, the client's trust must remain months and years after the settlement, not only so that the client remains satisfied, but also so that the client sends other clients in the future.

Late mediation is also beneficial because it gives the client a chance to experience the stress of prosecuting the case, and it gives the client a good opportunity realistically to evaluate strengths and weaknesses. Late mediation helps the client make an informed decision, and it gives the client time to gain perspective into the dispute, and to "practice" in the event the case does not settle. An early mediation is less useful, not only because it tends to be less stressful, but also because the client is less well-prepared to "testify" and thus learn the best way to present the case.

Giving the Brokerage Attorney a Chance To Get to Know the Weaknesses of his Client and a Chance to Get Busy With Other Things

A good advocate is a good educator, able to teach his adversary not only what the case's strengths are from the investor's point of view, but also what the weaknesses are from the firm's point of view. Just as plaintiff's counsel can be unrealistic about a case, so can a defense attorney. At first inspection, the defense attorney almost always sees a broker who appears sincere (a qualification for employment), a manager who seems careful, concerned and confident, and an investor who has told his broker too much about other accounts, other investments and other things, all of which appear to give the firm the advantage.

At this stage, it is best for the investor's attorney to sit back for a while. Let the broker's attorney produce the firm's documents; there is usually good stuff in there that was not looked at by the firm's attorneys in the early stages. And after a few interviews, that broker and manager may well appear to be more vulnerable as witnesses than originally thought. Add that to the usual measure of "lawyer paranoia" (which comes from being part of the arbitration community, where inexplicable things can and do happen), and it can be seen that the best time to settle is late, when the busy defense lawyer will look in his calendar, see four more cases in the next few months, and think - maybe I should get rid of this one, because I don't have as much time as I'd like to prepare to try it. At these latter stages, the bravado and determination that accompanied the answer is likely to have receded, and the businesspeople's assessment of the cost (and danger) of going ahead will be more realistic.

Conclusion

Every case is different, and every case, every client, every adversary must be treated individually. With the understanding that generalizations can be poor guides, the general feeling of this author is that mediation is best conducted late, rather than early, in the life of a case. In that way, the mediation is likely to produce the optimum result - a client who is satisfied (in the long run) with a settlement, and, if no settlement is reached, an attorney and a client who are prepared to win the hearing.

With this timing in place, our firm approaches the mediation as we do the arbitration - our exhibit book will be prepared, our damage calculations refined and double-checked, our witnesses ready to go. Then, the mediation will be useful as practice for the hearing, as well as being an efficient way to conduct negotiations. Then, both client and attorney are sure benefit, whether the case settles or not.

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Eighth Circuit Court of Appeals Upholds Arbitral Immunity for the NASD

The U.S. Eighth Circuit Court of Appeals upheld arbitral immunity for the NASD in the suit brought against it

by a former broker who objected to the NASD's actions in his arbitration against his former employer. ***Honn v. NASD***, 182 F.3d 1014 (8th Cir. (Mn.)).

After the broker left his firm, he filed a claim against the firm and alleged that the firm had wrongfully put a negative comment on the broker's U-5. The broker's claim was presented to a panel of NASD arbitrators and the arbitrators awarded a monetary relief. However, the broker was dissatisfied with the arbitrator's determination of damages and brought an action in state court to vacate the arbitration award. The broker based his motion to vacate on grounds that an NASD employee had improperly testified as a witness for the firm an that an NASD staff attorney had engaged a improper communication with one of the arbitrators.

The state court vacated the award an a second arbitration was scheduled. The broker then found out that the NASD had provided the second panel of arbitrators with documents revealing the amount of damages awarded by the first panel. The broker then successfully moved in state court to have the second panel disqualified and a third panel was appointed. After the third panel was appointed, the broker learned that the firm had lined up a new witness who was also a former employee of the NASD. A state court dismissed the third panel and stayed the arbitration after the broker filed an action in federal district court against the NASD

The federal court action alleged various constitutional statutory claims and state common law claims against the NASD for depriving the broker of a fair disposition of his claims against the firm. The NASD moved to dismiss this complaint pursuant to federal rules of civil procedure 12(b) (6). Faced with the NASD's claim of arbitral immunity, the broker alleged that the conduct in question was not " in connection with" the arbitration process, and that the action in question was not necessary for the forum sponsoring the arbitration. The broker maintained that, because the non-arbitration arm of the NASD acted improperly, his claims were based on actions not necessary to and outside the scope of the NASD's arbitration-sponsoring role.

In granting the NASD's motion to dismiss, the Eighth Circuit stated "arbitral immunity protects all acts within the scope of arbitral process". The ***Hunn*** court went on to say that, like judicial and quasi-judicial immunity, arbitral immunity is necessary to protect decision makers from undo influence and the decision making process form attack from dissatisfied litigants. The court went on to conclude that the NASD was performing functions that were necessary to the arbitration administration at the time of the alleged wrongdoing. Therefore, the NASD's acts were in the scope of the arbitral process and even if the NASD carried out those functions improperly, the NASD is protected by arbitral immunity because the acts upon which the broker's claims were based were taken while the NASD were carrying out its normal administrative functions.

Florida State Court Vacates Attorney Fee Award

In ***Barron Chase Securities, Inc. v. Moser***, 1999 WL 510632 (Fla.App. 2 Dist.), the Claimant asserted multiple claims for damages against Barron Chase before an NASD arbitration panel. Her claims were based on several common law theories of recovery which would not support her entitlement to attorneys fees, as well as a statutory claim under the Florida Securities Statute which would support recovery of attorneys fees by the prevailing party. The Claimant recovered a monetary award and therefore necessarily prevailed on one or more of the claims. Although the Claimant expressly asked the arbitrators to specify the basis for any damages awarded, they failed to do so.

The Claimant subsequently filed motions in circuit court in Florida to confirm the arbitrator's award and to recovery attorneys fees. The final circuit court judgment confirmed the arbitrator's decision and awarded over $60,000 in attorneys fees. On appeal, Barron Chase argued that, because the award did not specify whether the Claimant prevailed on common law claims or on statutory claims, the trial court did not have a basis upon which to award attorneys fees.

The court stated that, although the arbitrators are authorized to simply inform the parties whether the award is based on a theory that will entitle the Claimant to attorneys fees in subsequent court proceedings, without citing specific authority, the failure to specify the basis for any damages awarded or authorizing the awarding of attorneys fees, precludes the later judicial award of fees.

New York U.S. District Court Dismisses Motion to Vacate for Lack of Subject Matter Jurisdiction

The United States District Court for the Southern District of New York dismissed an action which was filed pursuant to Section 10 of the Federal Arbitration Act seeking to vacate an arbitration award. ***Perpetual Securities, Inc. v. Wang,*** 1999 WL 619640 (S.D.N.Y.)

The court stated that the FAA, including Section 10 which was the basis for the motion to vacate, does not confer subject matter jurisdiction on a U.S. District Court. The court went on to explain that an action brought pursuant to the FAA must assert a basis for subject matter jurisdiction that is separate from the FAA, such as diversity of the parties or the presentation of the federal question. Both parties admitted that the amount in controversy was insufficient to trigger diversity jurisdiction pursuant to the FAA must assert a basis for subject

matter jurisdiction that is separate from the FAA, such as diversity of the parties or the presentation of the federal question. Both parties admitted that the amount in controversy was insufficient to trigger diversity jurisdiction pursuant to 28 U.S.C. Section 1332. Since no diversity jurisdiction was present, the only basis for subject matter jurisdiction was that the petition itself presented a federal question pursuant to 28 U.S.C. Section 1331. The fact that the arbitration underlying the dispute may have involved the resolution of federal claims, does not mean that the U.S. District Court has subject matter jurisdiction over the petition to vacate. In order for the court to have jurisdiction, the petition to vacate itself must present the resolution of a federal question.

The motion to vacate included the garden variety claims that the arbitrators exceeded their authority, committed various acts of misconduct and manifestly disregarded the law. The court concluded that none of those claims presented a substantial question of federal law and therefore the court could not exercise subject matter jurisdiction pursuant to 28 U.S.C. 1331.

Recent NASD Arbitration Awards

Parker v. Schwab — NASD Arb. No. 98-02325

Claimant alleged that he was persuaded through misrepresentation to purchase Schwab's StreetSmart software to enable him to conduct trading in his account at Schwab through his personal computer. Claimant further alleged that the software did not contain or provide all the information promised so the information provided to him was misleading causing him financial losses in connection with the trading of his investment in Best Buy ("BBY").

Schwab denied the allegations and countered that the brochure delivered clearly informed the Claimant that additional charges applied for some services. Schwab further maintained that Claimant's claim that the losses were caused by missing information was suspect because the Claimant had used StreetSmart for 18 months before his problem with BBY shares. Schwab further alleged that Claimant's losses were solely caused by unrealistic limit orders placed by the Claimant to cover his short position .

The arbitrators awarded Claimant $9,000. Randall Henley of Palm Beach, Florida represented the Claimant.

King v. Paradise Valley Securities — NASD Arb. No. 98-01193.

Claimant alleged that Paradise Valley Securities induced her to open three account and in those account purchased private initial public offerings and low price securities and traded on margin. Claimant further alleged that respondent bought speculative securities without regard to risk diversification and placed unauthorized trades in her account.

Respondent stated that the risk and speculative nature of the securities purchased were discussed with the Claimant; that all trades were authorized; and that the Claimant provided financial information in private placement memorandums which indicated her investment objectives were consistent with the risk involved in those investments.

Claimant requested an award of $236,000 as compensatory damages and an additional $630,00 under the theory of a properly managed portfolio, plus attorneys fees and costs. The arbitrators awarded $278,000 as compensatory damages and $45,000 in attorneys fees. The Claimant was represented by William D. Nelson of Denver.

Tamm v. Janney Montgomert Scott and Rayfield J. Jones — NASD Arb. No. 98-00359.

Claimant alleged that the respondent fraudulently induced him into purchasing four securities: Hospitality Group, African Import/Export, Black Movies and Entertainment and Silver. Claimant further alleged that Jones represented that the investments were offered by Janney that Janney had fully investigated the investments and that the investments were consistent with Claimant's investments objectives. Claimant further alleged that he was guaranteed that the investments were secured by promissory notes and personal guarantees.

Janney denied the allegations and contended that if any of the investments were offered by Jones, they were private security transactions without Janney's knowledge, participation and consent, and that Jones was not acting withing the scope of his employment.

Claimant requested damages in amount of $196,000 plus treble damages of $600,000. The arbitrators awarded $310,000 in compensatory damages and denied the request for attorneys fees and punitive damages. Claimant was represented by Theodore H. Jobes of Philadelphia.

American Ban Credit v. Merit Capital Associates and Anthony Padro — NASD Arb. No. 98-02261

Claimant alleged that he was an unsophisticated investor who was convinced to buy shares in Sigma Designs because the price was guaranteed to rise dramatically in a short period. When the price of the stock declined, Padro convinced Claimant to buy additional shares of the stock, and that, after the purchase, a majority of the Claimant's investments were in one low-priced, speculative security. Claimant additionally maintained that the respondent marked the price of Sigma Designs up and that the fact the respondent was a market maker in the security was not fully disclosed to Claimant.

Respondent denied the allegations and claimed that the Claimant was a sophisticated investor who held himself out to the federal government as a manager of investments on his tax return. Respondent further alleged that the majority of the Claimant's losses were due to the fact that he was sold out after refusing to meet margin calls and that he later bought the stock back again at a higher price.

The arbitration panel awarded $98,000 in compensatory damages plus interest at 8%. The Panel denied Claimant's request for punitive damages and held that each party should bear their own costs, including attorneys fees. The Claimant was represented by Darren C. Blum of North Miami, Florida.

Terry v. Lexington Capital Corp. — NASD Arb. No. 98-03001

Claimant was a customer of Lexington Capitol Corp., now know as Preston Langley Asset Management. Claimant alleged that respondents made material misrepresentation regarding IRT Industries and recommended that he purchase securities in IRT that were unsuitable for him and used deceptive, unfair and misleading sales tactics to pressure him into buying more than $400,000 of the security . Respondents alleged that the Claimant was a sophisticated investor who had previously purchased high risk stock on margin in his Schwab account.

The panel awarded $450,000 in compensatory damages jointly and severely against Lexington and the brokers involved. Claimant's demand for punitive damages was denied and the parties in the arbitration panel ordered the parties to bear the own respective costs, including attorneys fees.

Berkley v. Ferris, Baker Watts — NASD Arb. No. 98-01257

Claimant was a 73 year old widow who alleged that she had been investing in conservative dividend-paying stocks and tax free bonds. In 1996 respondents recommended covered call options to increase her income with a representation that a covered call option strategy involved no risk of capital. Subsequently, many of the shares of stock in her portfolio were sold, on which sales she incurred substantial capital gains tax liability.

Respondent maintained that it acted with the appropriate duty of care toward Claimant and breached no fiduciary duties with respect to her account. Respondent further maintained that Claimant understood the covered call writing program and that they were justified on relying on Claimant's representation concerning her willingness to participate in the program.

The arbitration panel awarded $142,000 in compensatory damages without prejudgment interest. Claimant's request for punitive damages was denied and the parties were ordered to bear their own respective costs, including attorneys fees. Morris J. Levin, Washington D.C., was the attorney for Claimant.

Tinsley v. GKN Securites — NASD Arb. No. 97-03015

Claimant alleged that respondents solicited them to allow respondents to manage a portion of their investment portfolio with the primary objective of identifying purchasing stocks with a potential for spectacular long term growth and that once respondent gained control of their account, it began to churn their account with a purpose of maximizing commission income by heavily trading on margin. Claimants further alleged that respondent recommended that they purchase house stocks which were motivated by a financial incentive of secret concessions that respondent's brokers received that were in far of access of the indicated mark ups on the stocks

Respondents alleged that the Claimants were experienced investors with investment objectives that included speculation; that they had developed a relationship with the respondent's broker at two other brokerage firms prior to their opening account with respondent; and that a speculative pattern of short term trading with margin had been used in those previous accounts.

Claimants requested compensatory and punitive damages in the amount of $4,200,000. The arbitration panel awarded compensatory damages of $250,000; denied Claimant's request for punitive damages; and directed that the parties shall each bear their respected costs and expenses, including attorneys fees.

Allespach v. John Hancock and WMA Securities — NASD Arb. No. 98-00342

Claimants alleged that respondents, through their broker, recommended that Claimants invest in unregistered fraudulent securities issued by First Lenders Indemnity Corporation. Claimants alleged that respondent's broker, while a licensed agent with both John Hancock and WMA, made false representations including that the promissory notes were secure investments and an alternative to CD's. Claimants further alleged that John Hancock and WMA were responsible for the broker's violations in their positions as controlling persons over the broker and that WMA and John Hancock failed to meet their burden of establishing that they exercised reasonable supervision over the broker.

Claimant requested actual damages in the amount of $300,000, lost opportunity costs, attorney's fees, and punitive damages. The arbitration panel ordered compensatory damages of $280,000, plus interest at 8%,

but denied the Claimants request for punitive damages and attorneys fees.

Nicholas v. Belfort, Buxton, Green, Porush and Bear Stearns — NASD Arb. No. 98-02450

Claimants alleged that respondents churned their account, executed unauthorized trades, recommended unsuitable investments, and manipulated the market involving the stocks that were sold to Claimants while Claimants carried an account at Stratton Oakmont .

The individual respondents claimed that the statute of limitations had run and that Claimants freely consented to all the transactions in their account and the attendant risks, and that the individual respondents at all times acted in good faith.

Bear Stearns asserted that the written agreement between Claimant and itself precluded the awarding of damages, as its sole function was to act as a clearing agent to Stratton Oakmont.

The panel awarded $293,000 in compensatory damages jointly and severely against Buxton and Belford and $1,000,000 in punitive damages pursuant to ***Mastrobuono v. Shearson Lehman Hutton***. The award does not reflect damages against Bear Stearns or an award of attorney fees.

Aggarwal v. Everen — NASD Arb. No. 98-02255

Claimants alleged that respondent, through its broker, caused 65 % of its profit sharing and money purchase retirement plans to be invested in a singular security called Projectovision, which the broker indicated was a conservative investment. The security declined 90% in value of its original cost or 60 % of the entire value of the retirement plan. Claimants further contended that the respondents had a financial relationship with Projectovision which was not disclosed and that the purchase violated both rules of the NASD and applicable ERISA regulations.

Respondents alleged that the Claimant was an experienced investor whose investment objectives on the new account form reflected trading and speculative capital appreciation.

Claimants requested a reward of $300,000 in out-of-pocket losses; $700,000 for lost opportunity cost if the retirement plans had been prudently handled; attorneys fees; and $1,000,000 in punitive damages. The arbitration panel awarded $183,000 in compensatory damages and $19,700 in interest, but denied the claim for attorneys fees and punitive damages.

Mersten v. Olde Discount — NASD Arb. No. 98-02255

Claimant alleged that respondent, through its broker, exercised control over Claimant's account and engaged in transactions that were excessive and unsuitable to Claimant given her financial objectives .

Respondents denied the allegations in the statement of claim, alleging that the losses were the result of the Claimant's aggressive trading strategy and outside market forces and from regular withdrawals from the account.

Claimant requested an award against respondents for compensatory damages of $450,000 and punitive damages of $50,000. The arbitrators dismissed the statement of claim in its entirety. Claimant was represented by James J. Eccleston, Chicago, Il.

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From the Professor

RETURN TO BASICS III: DUTY TO MITIGATE DAMAGES

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In this article and the one to follow in the next issue, I want to return to the basics concerning three interrelated topics which are often raised in arbitration by defendant brokers. These topics are: (1) Duty of the plaintiff customer to mitigate damages; (2) Duty of the purchaser of securities to perform "due diligence"; and (3) The place in securities arbitration for the concepts of contributory or comparative negligence of fault. This Quarter's Column will be devoted to the first of these, mitigation of damages, while Winter's Column will cover purchaser's "due diligence" and comparative fault issues.

The issue as to a customer's duty to mitigate has come to the fore because of the recent adoption of the Appendix to the NASD Arbitration Manual indicating that one group of documents that brokers are entitled to discover are those involving any attempt by the claimant customer to mitigate his damages.

Such discovery puts the claimant customer in a "no-win" situation. In most cases, the claimant customer will not have attempted to mitigate. If he discloses this fact, then the broker will use this as an admission that there was no attempt at mitigation. If the claimant doesn't disclose it, the broker will do two things. First, he will claim surprise, and seek exclusion, if any evidence of mitigation is introduced during the hearing. Second, if no evidence of mitigation is presented at hearing, the broker will then claim an inference that no mitigation was done. The obvious way to avoid this

"no-win" situation is to attack the need to disclose information about mitigation, arguing that there is not duty to mitigate. If there is no duty to mitigate, any such evidence on the subject is irrelevant. This column will examine whether there is a duty to mitigate in connection with the most common types of claims filed in customer arbitrations. The surprising answer, contrary to the position of the NASD and brokers' counsel, is that in the case of most securities claims ***there is simply no duty to mitigate.***[1]

I. PIABA's Long Running Dispute with the NASD Over Mitigation.

PIABA has had a long running dispute with the NASD over the issue of mitigation and its treatment in the NASD arbitrator materials. In November 1996, the NASD issued both its Chairperson Course Preparation Guide and the Panel Members Course Preparation Guide for use in its mandatory training sessions for arbitrators. In both these publications, the following heading appeared: "The law assumes that people will take actions to limit their damages".[2] This heading was accompanied by the following text:

> Generally, the parties to an arbitration have a duty to mitigate (minimize) their damages. If a party could have prevented some of the damages for which it now seeks compensation in arbitration, but failed to do so, the panel may reduce any damages awarded to that party by the amount that could have been prevented.[3]

This idea was carried over into the NASD Arbitrator's Manual which stated: "The arbitrators may consider the concept of mitigation--that is the action the claimant could have taken to reduce or minimize the losses."[4]

This message was also being conveyed at the arbitrator training sessions themselves. PIABA's then President, Diane Nygaard, reported to Linda Fienberg of the NASD that:

> During the [arbitrators'] training I attended, the former Missouri Securities Commissioner took issue with these instructions, stating that in Missouri, not only is someone not required to sell a stock, but can keep some and sell others, and not waive damages for those kept. Unfortunately, the moderator was surprised at this assertion.[5]

President Nygaard's letter went on to point out that the case law indicates that mitigation is not required under the Uniform Securities Act and most state blue sky statutes.[6]

As a result of President Nygaard's letter, the NASD published a Clarification to its Guides, stating:

> State law varies as to when an injured party is required to mitigate damages. Some states require mitigation in all cases, while others do not require mitigation of losses caused by fraud. Most state blue sky laws do not impose a duty to mitigate damages. In cases where applicable state law imposes a duty to mitigate damages, a party is required to take ***reasonable*** steps to prevent losses within a reasonable time. If the arbitrators find that a party has a duty to mitigate, they may reduce any compensatory damage award by the amount of losses the injured party could ***reasonably*** have prevented.[7]

However, no change was made to the Arbitrator's Manual and the October 1996 continues to be distributed.[8]

Even the Clarification does not accurately reflect the state of the law. It is unfortunate that the NASD tries to advise its arbitrators on complicated substantive laws issues by simplistic statements of what it believes the law is. It is inexcusable when those statements are inaccurate reflections of the law. This is especially true when the inaccurate statement favors the position championed by its broker-dealer members. Such "mistakes" heavily tilt the arbitration process against the customer claimant and raise the question of the neutrality of the NASD arbitration process.

II. Nature of the "Duty" to Mitigate.

It is a fair general statement of the law that a plaintiff may not recover for injuries that he could have prevented. This rule originally developed in contract law, but is now also recognized in connection with tort damages. However, there are four important limitations to the general rule.

The first limitation is that, if such duty exists, it does not start until the investor knows or should have known of the violation. When the investor knew or should have known is obviously a question of fact.

The second limitation is that the "duty" to mitigate is not a duty at all as that concept is used in the law of torts. Rather, it is a general statement of law that a plaintiff, in some cases, may not recover as damages, compensation for injuries which he could have avoided ***after*** the discovery of the original wrongful conduct by the defendant.[9]

As the court in ***Theis v. duPont, Glore Forgan, Inc.*** stated:

> The rule, more properly stated, is simply that damages are not recoverable for harm that the plaintiff should have foreseen and could have been avoided by reasonable effort without undue risk, expense or humiliation.[10]

The court then quoted with approval from the Restatement of Contracts: "The law does not penalize [the claimant's]

inaction; it merely does nothing to compensate him for the harm that a reasonable man in his place would have avoided."[11]

The third limitation is in keeping with the idea of not allowing recovery for damages which could have been avoided. In many states, mitigation is affirmative defense [12] which the defendant must allege and prove.[13] Thus, the defendant must show "that the plaintiff failed to use every reasonable effort to mitigate his damages."[14] It would follow from this obligation that the defendant would also have the burden of establishing the amount that the plaintiff could have saved had he acted.[15]

The fourth limitation is that this rule is one applicable in the case of recovery of "common law" damages. As a result, it should have no place whether the plaintiff seeks an equitable or statutory remedy rather than legal "common law" damages. Thus, there should be no duty to mitigate where the remedy sought is either equitable or statutory rescission or rescissional damages.

III. Under Sections 12(1) and 12(2) of the 1933 Act.

It follows from this last limitation on the duty to mitigate that there is no duty to mitigate in the case of an action laid under either Sections 12(1) or 12(2) of the original Securities Act of 1933. Section 12 provides its own statutory remedy provision ***which is both exclusive and mandatory.*** The remedy provided is rescission, if the securities not been disposed of. The investor may "recover the consideration paid for such security with interest thereon, less the amount of income received thereon, upon tender of such security." In the event the securities have been sold, the remedy is ***rescissional (not common law) damages***. Since both remedies are essentially equitable in nature, the mitigation of damages rule has no application.[16]

The Supreme Court in ***Randall v. Loftsgaarden***[17] confirmed this conclusion as to Section 12(2). It also outlined the Congressional policy reasons behind the conclusion as well. It said:

> We may. . .infer that Congress chose as rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure as well as to make investors whole. Congress ***shifted the risk of an intervening decline in the value of the security to defendants, whether or not that decline was actually caused by the fraud.*** [Emphasis added.]

The Court went on to point out that the statute allows as the only set-off "the amount of income [actually] received thereon."[18]

In 1996, Congress modified the original Section 12 by adding a new Subsection (b) which reads:

> In an action described in subsection [12](a)(2), if a person who offered or sold such security proves that any portion or all of the amount recoverable under Subsection [12](a)(2) represents other than the deprecation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, as the case may be, shall not be recoverable.

This modification of Section 12 would appear to accomplish two things. First, as to now Section 12(a)(1), it acknowledged the correctness of the ***Loftsgaarden*** decision. No duty to mitigate. However, as to now Section 12(a)(2), it appears to override ***Loftsgaarden***, giving the defendant an affirmative defense of showing no causation. While lack of causation is broader than the duty to mitigate, it seems logical that the duty to mitigate should be considered a part of that defense.[19]

IV. Under Sections 410(a)(1) and (2) of the Uniform Act.

Sections 410(a)(1) and (2) of the Uniform Securities Act are modeled largely on the original Section 12 of the 1933 Act.[20] Also, as in the case of Section 12, Section 410 of the Uniform Act provides its own statutory remedy provision ***which is both exclusive*** [21] ***and mandatory.***[22] As a result, it follows that mitigation is also not a duty under the Uniform Act as it is not under Section 12 of the 1933 Act.

Following the reasoning of ***Loftsgaarden***, the court in ***Odmark v. Westside Bancorporation, Inc.***[23] so held. It said:

> There is every reason to believe that the Washington Supreme Court would adopt the reasoning set out in [***Loftsgaarden***]. Like § 12(2), [Section 410] expressly provides for a rescissionary measure of damages and expressly limits offsets to the "amount of income" received from the securities.

This case is particularly important because the court during the trial of the case gave, over the objection of the plaintiff, a jury instruction that the plaintiff had a duty to mitigate. Considering a post-trial motion by the plaintiff, the court held that it had erred in giving the mitigation instruction. Clearly, the court gave great thought to the issue before reversing himself.

V. Under SEC Rule 10b-(5).

The mitigation issue under SEC Rule 10b-(5) is complicated by the fact that numerous forms of recovery are allowed at the discretion of the trial court or arbitrators. Admittedly, cases can be found which hold that mitigation ***is a requirement*** under Rule 10b-(5).[24] However, these cases do not adequately consider the different forms of relief available under Rule 10b-(5). Nor do they consider the policy reasons or applicable general damage principals as to each form of recovery. When careful analysis is made of ***both*** the policy reasons and general damage principals applicable to each form of recovery authorized under SEC Rule 10b-(5), Arnold Jacobs in his treatise on SEC Rule 10b-(5)[25] concludes that mitigation is not required under any form of recovery.

Based upon the above analysis under Section 12 of the 1933 Act and Section 410 of the Uniform Act, policy would dictate that mitigation is not proper when rescission is the remedy allowed. This is true even though the language of the Rule does not require a rescissional remedy as do both Sections 12 and 410. As Jacobs says:

> No duty to mitigate should exist when the plaintiff obtains rescission or specific restitution [under Rule 10b-(5)]. Restitution is designed to deprive the defendant of his unjust enrichment, rather than to compensate the plaintiff for his loss. In contrast, mitigation of damages reduces the amount of the plaintiff's recoverable loss because he could have ameliorated that loss.[26]

Further, in the case of Rule 10b-(5), rescission is not a mandatory remedy as it is under both Sections 12 and 410. Therefore, rescission can be denied in favor of some other remedy, in those cases where the investor does not sue promptly after he has notice of the fraud.[27]

In the case of the out-of-pocket measure of damages, Jacobs points out that "the size of a damage award is fixed at the time of the fraudulent transaction."[28] Based upon this fact, Jacobs concludes that any "price movements after the fraudulent trade should be irrelevant."[29] He illustrates the point by using the following example. The stock is purchased at $10, but has an actual value of $8 at the time of purchase. Under the out-of-pocket measure of damages at the moment of purchase, the buyer's measure of damages is set at $2, $10 minus $8. The fact that the stock later drops to $5 is irrelevant. He still may only recover the $2.

The converse is also extremely important. If the stock later rises to $13, or three dollars more than he paid for the stock, he should still be entitled to recover $2. When he sells at $13, he makes only a $3 profit rather than the $5 profit he was entitled to.[30]

A modification of the out-of-pocket rule is the hybrid out-of-pocket rule. Under this rule, the true valuation date of the security is shifted to the date that the fraud is discovered by the purchaser.[31] Under the reasoning developed above in connection with the out-of-pocket rule, changes in value of the security, up or down, after that valuation date are irrelevant. The Eighth Circuit so held in ***Harris v. American Inv. Co.***[32] It then concluded that the buyer had no duty to mitigate.

Finally, Jacobs characterizes the ***Chasins*** measure of damages as similar to the hybrid out-of-pocket rule and concludes the same reasoning applies and no mitigation should be required.[33]

Conclusion

From the above analysis, it should appear clear that mitigation of damages has no place in suits or arbitrations brought under the three major securities act causes of action. If mitigation is not an element, either of the plaintiff's action or the defendant's defense, discovery on this issue is improper. Plaintiff's counsel should resist any attempt by the brokerage industry to seek to have the arbitrators compel such discovery, until it is clearly established that mitigation is in fact a relevant issue. Further, claimant's counsel may wish to tailor his theories of recovery to include only those claims where mitigation is clearly not an element.

Endnotes

1. As the quoted materials from the amended NASD materials admit, in some states, there is no duty to mitigate damages in connection with fraud. Breach of fiduciary duty is often treated as constructive fraud, one of the two breaches of fraud. ***See e.g.***, 15 Okla. Stat. (1991) §§ 57-59. However, the ***Rest.2d, Agency*** § 415, Comment b (1957), takes the position that an agent sued by his principal may avail himself of the defense of failure to mitigate. This rule appears to apply even when the breach is of obedience or loyalty.
2. NASD, ***Chairperson Course Preparation Guide*** 188 (Nov. 1996); NASD, ***Panel Members Course Preparation Guide*** 182 (Nov. 1996).
3. ***Id.***
4. NASD, ***Arbitrator's Manual*** 28 (Oct. 1996).
5. Letter from Diane A. Nygaard to Linda Fienberg, Executive Vice President of Dispute Resolution at 2 (Sept. 2, 1997).
6. ***Id.***
7. Attachment to Letter from Linda D. Fienberg to Dianne A. Nygaard (Feb. 9, 1998). Emphasis in the original.

8. The author received an arbitrator application packet in late September 1999 containing the original October 1996 Arbitrator's Manual. To the author's knowledge the November 1996 Training Course Materials have not been reprinted with the noticed change included.

9. ***Century 21 Products, Inc. v. Glacier Sales***, 74 Wash. App. 793, 875 P.2d 1238 (1994).

10. 212 Kan. 301, 307, 510 P.2d 1212, 1217 (1973).

11. Restatement, Contracts § 336, Comment d.

12. ***See e.g., Conder v. A.L. Williams & Assoc.***, 739 P.2d 634 (Utah App. 1987).

13. ***See e.g., Argenta v. Shahan***, 135 Mich. App. 477, 354 N.W.2d 796 (1984).

14. ***Webster v. Edward D. Jones & Co.***, 1999 WL 798881 (6th Cir. Oct. 8, 1999).

15. ***See e.g., Azemco (North America) Inc. v. Brown***, 553 So.2d 1245 (Fla. App. 1990). See also Section 12(b) of the Securities Act of 1933 as amended, 15 U.S.C. §77l(b).

16. ***Odmark v. Westside Bancorporation, Inc.***, 1988 WL 108288 (W.D. Wash. Mar. 9, 1988).

17. 478 U.S. 647, 659 (1986).

18. ***Id.***

19. It is not clear how Section 12(b) is supposed to work with the rescission remedy of Section 12(a)(2). In the case of rescissional damages, the amount of the loss not attributable to the misrepresentation or omission can simply be deducted. However, in the case where the remedy is true rescission, where the securities are still owned, there is no clear answer. One possible solution would be to go to a rescissional damages formula where no causation is established as to part of the loss.

20. **See** Official Comment to § 410, Subsection (a), Clause (2), 7B Uniform Laws Annot. 644 (1985).

21. ***See e.g., Ah Moo v. A.G. Becker***, 857 F.2d 615 (9th Cir. 1988); *Hines v. Data Line System, Inc.*, 114 Wash.2d 127, 787 P.2d 8 (1990).

22. ***Skurnick v. Ainsworth***, 591 So.2d 904 (Fla. 1991).

23. 1988 WL 108288 (W.D. Wash. Mar. 9, 1988).

24. ***See e.g., Arrington v. Merrill, Lynch, Pierce, Fenner and Smith Inc.***, 651 F.2d 615, 621 (9th Cir. 1981). ***See generally***, 5D Arnold S. Jacobs, ***Litigation and Practice Under Rule 10b-5*** § 260.03[f][iv] at 11-175, n.8 (1999).

25. 5D Arnold S. Jacobs, ***Litigation and Practice Under Rule 10b-5*** § 260.03[f][iv] at 11-175 (1999).

26. ***Id.*** at 11-178-11-179.

27. ***Id. See also Id.***, § 236.

28. ***Id.*** at 11-176.

29. ***See also*** **Danley v. Murphy**, 658 So.2d 483 (Ala. Civ. App. 1994) (mitigation is not applicable when damages are measured by the market price of the property before and after injury).

30. ***Id.*** at 11-177.

31. ***Id.*** at 11-178.

32. 523 F.2d 220, 227-228 (8th Cir. 1975).

33. 5D Arnold S. Jacobs, ***Litigation and Practice Under Rule*** 10b-5 § 260.03[f][iv] at 11-178 (1999).