

How to Win the Battle: Representing Wealthy and Sophisticated Investors at the Hearing

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INTRODUCTION

In today's current circumstances, it seems like every investor who brings an arbitration claim is deemed to be wealthy and sophisticated by defense counsel. As Seth Lipner said in a recent *Forbes* article, "The usual defenses include the sophisticated-investor defense, the blame-the-market defense, the prospectus-defense, the net-out-of-pocket defense, the failure-to-mitigate-damages defense and, most frequently seen, the blame-the-victim defense." According to the defense bar, virtually "everyone in arbitration is a sophisticated investor."²

In one sense, each of us will deal with an investor's wealth and sophistication in every hearing. It is important to recognize, however, that there are different degrees of wealth and sophistication. This presentation will discuss issues that arise in trying the case of an investor who is arguably comfortable financially, as well as those of an investor who is super wealthy and sophisticated.

The claimant that every defense attorney wishes for – and now more often than in the past frequently confronts – is the 45 year-old semi-retired company founder with an MBA who incurred losses as the result of an investment in a hedge fund or proprietary product, but whose net worth still exceeds \$25 million. Whether claimant's losses are \$500,000 or several million dollars, defense counsel thinks that, barring some evidence of egregious wrongdoing by the firm or other unforeseen circumstance, this is not a sympathetic claimant and the case is his to lose. While there may be a settlement offer on the eve of trial, this type of case has the greatest likelihood of going to a hearing.

Needless to say, representing a wealthy and sophisticated investor can be challenging. Regardless how egregious the misrepresentations and/or omissions to the claimant may have been, regardless how blatant and deliberate the brokerage firm's fraudulent actions were, more often than not, this type of case will present challenges. The sympathy factor that is attendant to some investor claims is missing; instead the envy factor may be present and increases exponentially with the claimant's wealth and sophistication.

The hearings of cases involving wealthy and sophisticated investors frequently resemble ships passing in the night. While the claimant's attorney focuses on the firm's

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² Seth Lipner, "The Usual Wall Street Defenses Aren't Working," *Forbes.com*, July 9, 2010.

misconduct and fraud, defense counsel puts the claimant himself on trial. Disregarding the wrongful conduct at issue, the defense's opening, evidentiary presentation, and closing are a scathing attack on claimant and his actions.

It's important to realize when representing wealthy and sophisticated investors that you must fully develop the nature and extent of the firm's misconduct. While less wealthy and sophisticated investors may be able to obtain a recovery by establishing that they wanted safe and conservative investments, unlike those which the firm misrepresented, arbitrators may be less inclined to enter a full award under these same circumstances for claimants who are truly wealthy and sophisticated. Our approach in dealing with the claims of these clients is to peel back the onion and focus on an in depth presentation of the misrepresentations and fraud associated with the sales and marketing of the product to show that important facts were not disclosed. By doing so, we are in a position to show that, no matter how wealthy and sophisticated the investor may be, it was impossible to detect the fraud perpetrated upon him. In short, a sophisticated investor can't use his sophistication if he is given false or incomplete information.

KEYS TO EFFECTIVE HEARING STRATEGIES

1. Concede Claimant's Wealth Upfront (if appropriate).

- One of your first steps in dealing with a wealthy client is to evaluate his or her wealth. What are the sources? Is it earned wealth or inherited? Liquid or illiquid? Is the wealth tied up in company stock and not readily accessible? How long has the claimant been wealthy? Is he newly rich or has he had these assets for many years? Is the claimant merely comfortable or is he among the super wealthy?
- Whether the claimant is an individual or institutional investor, it is essential that you address your client's wealth during your opening statement and the sooner, the better. One of the worst mistakes you can make is to try and hide your client's wealth from the arbitrators, especially if that wealth (for an individual) exceeds \$5 million. Defense counsel will surely raise it in opening and by acknowledging this upfront, you automatically diffuse the impact of the characterization of your client as somehow undeserving of or not needing a monetary recovery. Moreover, in product cases, investors are often not eligible to invest unless they meet a threshold of \$5 million or more in net assets.
- Make sure that the claimant admits that he is a rich man early during his testimony on direct examination. Frame your questions in such a way that they give your client the opportunity to explain how he made his fortune. Is he a self-made millionaire? Did he invent a product or start a business? If so, ask him questions that allow him to explain how his wealth came after years of hard work and perhaps early mistakes and failures as well. If his wealth comes from an inheritance, let him tell the

story of how his family acquired the assets since the source was almost always the result of someone's hard work.

2. Establish That Wealth Does Not Equate To Investment Sophistication (if appropriate).

- During the claimant's direct examination, ask questions that enable him to explain, for example, that while his nationwide chain of retail furniture stores has made him a multimillionaire and an expert in the furniture business, he has little or no understanding of the stock market or particular type of investments, and relies on his financial advisor at the firm to make investment decisions for him. An individual's success in business does not mean he is a sophisticated investor. Even a high net worth institutional investor may be unable to understand complicated investment strategies or complex investment products. In other words, show that sophistication is a relative term. An investor's sophistication in stocks and bonds, for example, does not mean that he has sophistication in municipal arbitrage.
- Consider using the shingle theory to justify claimant's reliance on the firm; the investor has no need to understand investments because the firm represents itself to investors as having the necessary expertise and will explain everything they need to know.

3. Force the Claimant to Take Adequate Time to Prepare for His Case and Testimony.

- Although they certainly want arbitrators to render an award in their favor, some wealthy clients have a tendency to take an almost dismissive or cavalier attitude toward their case. When calling about discovery responses or the need to produce certain documents, your client may give you the impression that you are bothering him with a minor matter. This is understandable. For many wealthy and especially super wealthy claimants, a loss of \$5 million or more represents only a small percentage of their total assets. If a claimant is the CEO of a large conglomerate or travels extensively in connection with his business, he is genuinely busy and may resent spending the time needed to adequately prepare for the hearing and his testimony. Isn't that what he hired you to do? You must convince your client otherwise. He may resist your urgings to do so, however, it is imperative that you make him take the time to help prepare his case and, especially, to prepare for his testimony. The key to a successful hearing is for the claimant to take the time beforehand to recall meetings, telephone calls, etc. that he had with the broker and collect and review all documents. Most important, the claimant must be clear on all the facts and convey them to you. The only way to do this is for him to spend whatever time is necessary.
- While you certainly want your client to devote time to his case, be aware of and pay special attention to his activities and obligations. Many

wealthy clients have schedules in which they work 12 to 14 hours a day and legitimately don't have much extra time to devote to their case. To the extent possible, help your client focus on the essentials and try and accommodate your schedule to his when necessary.

- Take advantage of your client's preoccupation with his business or profession and demanding work schedule to explain to the arbitrators why he didn't pay closer attention to his account, or why he relied upon what the broker told him about a particular investment product rather than conducting his own investigation, if possible. The answer: he simply didn't have the time to do so. This is a legitimate explanation.
- In addition to preparing the claimant for his direct testimony, you must also prepare him for cross-examination. Do not be intimidated by your client's wealth or desire to make things easy for him; brace yourself to ask the hard and sometimes embarrassing questions. These include questions about his past investment activity and relationship with the broker as well as more personal background questions. It is far better for you to ask them now than for your client to be taken aback by a surprise question from defense counsel, a mediator or one of the arbitrators.

4. Make Sure You Know Your Client.

- It is essential that you know exactly what information about the claimant is in the public domain. Even if you have discussed his background at length and your client assures you there are no skeletons in his closet, have your assistant do research to verify this. Your client may well believe in full disclosure, and may simply have forgotten the drunk driving arrest, or the district court case that settled a few years ago in which he, along with his company, were defendants. Insist that an assistant Google the claimant and review every hit. While she may find nothing other than websites that include his contributions to various charities or pictures of your client at golf tournaments and nonprofit fundraising events, there may be some less desirable revelations as well. Make sure that the Internet research is not limited to Google; insist that Facebook, LinkedIn and other social and professional media are searched as well. You can be certain that the defense has run these searches; you must do so also.

5. Help the Claimant Establish a Good Rapport with the Panel.

- While establishing a good rapport with the arbitrators is essential in all hearings, it is particularly important when the claimant's wealth exceeds several million dollars. The arbitrators' perception of the claimant is very important and one of your goals is to present him as a likeable and engaging individual. Arbitrators are much more likely to give an award to a claimant that they feel is deserving.

- Many super wealthy clients live in a rarefied atmosphere above the clouds where all their needs and desires are catered to without question. These clients are not accustomed to having their backgrounds and activities questioned and, knowingly or not, some tend to project an aloof and pompous demeanor when confronted. An attitude like this before the arbitrators is problematic at best. At worst, it may turn the arbitrators completely against the claimant and result in a zero award. Remind your client that defense counsel is only doing his job and to respond to all questions politely and refrain from showing any annoyance or irritation. Courtesy is important.
- More often than not, the arbitrators' own financial assets pale in comparison to those of the wealthy claimant, and feelings of resentment and jealousy may well arise. Diminish the impact of these feelings by giving your client the chance to show how his wealth helps or has helped others in the past. Has his business created jobs for the community? If, for example, the losses he incurred in his account prevent him from hiring more employees for a company or business he owns, give him the opportunity to explain this. If claimant's charitable contributions have declined or his plans to establish a nonprofit foundation have ended due to account losses, make sure the arbitrators know this. If, for example, the claimant rose from humble circumstances and helps support extended family members or pays for the college education of nieces and nephews, he should refer to this fact in his testimony.
- Even if claimant's losses represent only a relatively small percentage of his wealth, focus on the wrong perpetrated by the firm and show that the claimant is entitled to recover damages regardless of his wealth. A brokerage firm and/or its representative should not be allowed to lie to any investor and suffer no consequences.

6. Establish That Claimant's Due Diligence Was Adequate.

- If an individual claimant's wealth is such that he has a team of financial professionals and/or personal advisors that help select or review investments for him, be sure that the arbitrators are aware of this. Claimant did his due diligence by hiring these experts and was justified in relying on their expertise. If the firm and its representatives misled claimant's experts, he is entitled to a recovery.
- The same is true for an institutional investor; an investment committee or money managers is typically designated to make investment decisions for the entity and relies on the firm's representations to them. If the firm misled the institution's experts, the institution is entitled to a recovery.
- In cases involving a private placement memorandum, if the claimant is indeed sophisticated and has read and understood the document,

including the risk disclosures, emphasize this fact. This approach will help you explain to the arbitrators the impossibility of the investor detecting the fraud given the misrepresentations and/or omissions in the PPM. Even a truly sophisticated investor cannot protect himself against fraud.

- If, on the other hand, the claimant simply relied on what the firm's broker told him about the investment and failed to read the PPM and subscription agreement, resist the temptation to hide this fact. Let the claimant admit this fact during his direct examination. Allow the claimant to tell the arbitrators that, despite language in the subscription agreement and/or other documents regarding non-reliance on the firm's representatives and reliance on his own advisors, he believed that the broker was his "financial advisor."

7. Explain That Wealth Does Not Make an Investment Automatically Suitable.

- Although cases brought by wealthy claimants often involve a firm's defective proprietary fund or other product where suitability is mentioned only in passing, it is important to point out that suitability can nonetheless be an issue. Focus on the client's investment objective and/or the part of the portfolio that the client was purchasing the investment for. If, for example, a firm misrepresents a fund as a fixed income alternative that has only a slightly greater risk than municipal bonds and claimant sold municipal bonds or other fixed income investments in his portfolio to take advantage of the fund's slightly higher interest rate, the fund was an unsuitable investment for claimant. The fact that the claimant believed the fund was a fixed income investment does not make it suitable even though he could afford the risk of principal loss.

8. Make the "Too Smart to Be Stupid" Argument.

- After conceding that claimant is wealthy, sophisticated, smart and very successful in his business or profession, pose a question to the arbitrators regarding his motive for investing in the particular product or fund that caused the losses. For example, if the firm marketed an investment as safe and low risk, question why a rich, intelligent, experienced investor would put his money at risk only to earn a slightly higher rate of return? Why would an investor who had already amassed great wealth and didn't need another home run take the chance of losing his principal to gain a few extra points? Show that it makes no sense for your client to have made the investment unless the firm and/or his broker failed to disclose the true risks involved or otherwise misrepresented the product. In other words, claimant is too smart to have made such a stupid investment decision.

9. Anticipate Defenses and Refute Them in Advance.

- As Seth Lipner stated in his recent *Forbes* article cited above, in addition to the sophisticated investor defense, standard defenses include the blame the market defense, smart and rich defense, prospectus defense, net out of pocket defense, failure to mitigate damages defense, and blame the victim defense. You should not wait for opposing counsel to raise these defenses. Be prepared to address and refute them in your opening. This goes a long way toward diffusing their effectiveness.

10. Rely on Legal Arguments to Prove Your Case.

- While we should always be prepared to point to a statute, SEC rule or release, FINRA interpretive memos, case law or other legal authority to support the claims set forth in the Statement of Claim, the trend is to present the law to the arbitrators in a pre-hearing brief rather than at the hearing. If, however, despite your best efforts, you get the sense that the arbitrators do not have a favorable view of your client, or his testimony on direct or cross was less than successful, consider using FINRA rules and interpretative cases or other legal authority during your examination and closing argument. The cites may make the difference between the arbitrators ruling against the claimant simply because of his personality and deciding that they must award him damages because that is the law or the rule.

11. Engage a Well-Known and Respected Expert Witness.

- Although an expert witness may be viewed as added insurance to bolster a typical investor's case, and engaged only if the client can afford the expense, an expert witness is almost a necessity if the claimant is wealthy. Most arbitrators have come to expect expert witness testimony in cases where the damages exceed a million dollars and may be somewhat skeptical of the merits of a claim without expert witness support. Defense counsel will almost always hire expert witnesses when the damages are substantial. Be prepared to do the same and engage the expert sooner rather than later since his insights may help you prepare your case. Even if there is ample evidence of the firm's wrongdoing, it is still wise to engage a well-known expert whose views are respected in the industry and the securities bar.

12. Don't Hesitate to Use Charts and Other Demonstrative Exhibits.

- While PowerPoint, Trial Director and other computer-driven programs are undoubtedly helpful in making effective presentations at the hearing, consider using, in addition to these or as an alternative, chart books and other demonstrative exhibits to prove your case. Although arbitrators

frequently complain about the number of exhibit notebooks or volume of paper given to them at the hearing, the fact remains that there really is no substitute for having a hard copy of an explanatory chart, incriminating email, or table that summarizes the evidence. Although the arbitrators' memory of what they see on a screen may be fleeting, the impact of a chart book in front of them while a witness is testifying or can flip through during a break in the proceedings or award deliberations is long lasting. Chart books and other demonstrative exhibits are expensive, however, given the size of most wealthy investors' claims, they are well worth the cost.

13. Pay Particular Attention to the Arbitrators.

- In a large multimillion-dollar case we had several years ago in which the claimants were super wealthy and sophisticated investors, we held a mock arbitration hearing with actual arbitrators from the FINRA pool. Much to our surprise – and dismay – while all the arbitrators found that we had proven actual fraud, they had substantially different reactions to our case. Some were highly offended by the firm's actions and awarded damages close to the amount we sought. Other arbitrators awarded damages, but a smaller amount, and said that the claimants shared some responsibility with the firm for their losses. And some arbitrators said that even though the firm had violated the law, a zero award was appropriate. Make sure you have an associate or legal assistant at the hearing to observe the arbitrators' reactions to testimony and be prepared to make adjustments to your case when necessary.