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As stocks fall lawsuits rise

By Christopher Guly
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The recent market meltdown that has left holdings in many investment portfolios down or depleted has also led to "an unprecedented" number of investors wanting to sue their investment advisors, according to Toronto lawyer Hugh Lissaman, who has never witnessed such a litigious atmosphere during his 16 years practising in the area of stockbroker-investment dealer litigation.

On any given week, Lissaman receives at least six phone calls from potential clients who've lost money in the market.

Usually, they don't want to commence legal action against their advisors — but some feel they have no choice, explains Lissaman, who, nine years ago, established a solo practice that now deals mainly with this type of plaintiff work.

After reviewing a would-be client's brokerage statements, he decides whether any dips are the result of a decline in the market or caused by alleged broker negligence, where there may be a cause of action.

"If someone is looking to the brokerage firm for some resolutions or mediation down the road or to a pre-trial judge or judge, the question I put is: 'I lost money on the market too. What makes your case a negligence case?' " offers Lissaman, who was counsel for the defendant in the precedent-setting Ontario case, *Blackburn v. Midland Walwyn Capital Inc.*, [2003] O.J. No. 621 (S.C.J.), which addressed such legal issues as the duty of firms to warn clients about rogue stockbrokers who have recently had their employment terminated.

Yet sometimes the signs are quite obvious that something untoward has occurred.

For instance, a 78-year-old woman, who had lost money in 14 mutual funds, contacted Lissaman for help. He, in turn, passed her portfolio to veteran securities industry compliance expert Douglas Fox, the founder and principal of Toronto-based Risk Management Services Inc., for review.

Fox determined that of the 14 mutual funds she held, 12 were considered "high-risk" and the remainder "medium-risk," according to industry analysts.

"That lady had no business being in those mutual funds," says Lissaman. "She was relying on her portfolio to pay her monthly expenses and was given bad advice and inappropriate investing for her situation. She would have a case."

He estimates that there are only a handful of independent Toronto lawyers who focus on representing plaintiffs in stockbroker negligence cases. (Lawyers attached to large firms might be in a conflict situation because they act for the institutions possibly targeted for a suit, he adds.)

Once Lissaman decides that a client has a case, he sends a complaint letter to the institution or individual who provided the investment advice, outlining problems with the portfolio. If the matter is not resolved in that fashion, he files a statement of claim and a court file is opened.

To properly prosecute the case, Lissaman hires forensic experts, such as Fox, to determine the suitability

and risk level of a client's investments and, if there was leveraging where money was borrowed to purchase bonds or stocks without the client's knowledge, to explain to the court how that amplifies the risk attached to an investment.

To calculate damages in these cases, Lissaman turns to Peter Weinstein, a partner with Stern Cohen LLP and head of the Toronto-based accounting firm's specialist practice, Stern Cohen Valuations Inc.

A chartered accountant who also holds certification as a chartered business valuator and specialist designation as an investigative and forensic accountant, Weinstein quantifies any damages that might have been incurred as a result of a bad investment.

He will look at the capital put into an account and what was taken out. If a stock had significant appreciation, the loss should be viewed in relation to the funds invested, "rather than only from its peak value," says Weinstein.

As well, he will identify what the investment income or losses should have been if the capital was appropriately invested — according to the investor's objectives — in equity, bonds or a combination of the two.

Weinstein compares the investment with the appropriate index.

For instance, for the three-year period that ended May 31, 2009, returns (assuming dividends and interest were reinvested):
- on bonds were 18 percent on the DEX Universe Bond Index;
- on Canadian equities were four percent on the S&P/TSX (Toronto Stock Exchange) composite index; and
- on U.S. equities were 23 percent on the S&P 500 index and 18 per cent as per the Dow Jones Industrial Average.

"There will be situations where a client would have incurred some losses, but they may be different than the ones they should have incurred," explains Weinstein, who adds that management fees and expenses should be deducted from what would have been earned. If money was withdrawn from an investment account, that too has to be reflected in the calculation of any losses.

"My recommendation to lawyers is to consider all of this early on in the process because litigation is expensive and it's helpful for lawyers to know the extent of the losses before they spend a lot of time and incur a lot of costs," says Weinstein.

Beyond preparing damages reports for lawyers, he's also appeared in court as an expert witness, as he did in the Ontario Superior Court of Justice case, *Davidson v. Noram Capital Management Inc.*, [2005] O.J. No. 4964.

Based on his calculations, which included reasonably anticipated rates of return, the eight plaintiffs (most of them seniors) lost nearly $1.3 million. In his decision, Justice Peter Cumming awarded them almost $1.2 million for financial losses and prejudgment interest.

Weinstein expects that when the dust settles from last year's market plunge, there will be more cases of investors suing their advisors.
Already, the Investment Industry Regulatory Organization of Canada (IIROC) reports that complaints filed this year with brokerage firms are up 35 percent — and have increased by 90 percent since 2007.

But resolving lawsuits could take time.

Weinstein says he's still working on cases that date back to 2001 — as is Lissaman, who also expects the number of investor plaintiffs to grow.

"There are problem brokers out there, but I have to look at each client complaint that comes in and assess what's gone on in the portfolio," he explains.

"Sometimes it's a case where the money just got parked and was never looked at again. It doesn't necessarily mean the broker was bad, but perhaps just inattentive.

"Other times, the broker did some really proactive trading with a purpose to make him money at the expense of the client. Those cases come up as well, but not as often."

However, he is concerned that with the investment industry having lost a lot of money when the markets took a nosedive, some advisors may "look to make up that lost ground by once again investing people in some things they shouldn't be investing in."

Lissaman recently represented a single mother of three children of modest means who had won a $2-million lottery and had a broker invest the money.

"He abused that trust and her ignorance, and totally mismanaged her portfolio," says Lissaman. "It started about six years ago, but only recently has the extent of the mismanagement come to fruition."

The woman lost a lot — but not all — of her winnings. In July, an IIROC hearing panel permanently banned Julius Caesar Phillip Vitug, the broker, from working as an investment dealer, fined him $350,000 and ordered him to pay $80,000 in costs. "He acted deceitfully" and showed "no remorse for his actions," said the panel, which found that between about April 2003 and August 2005, Vitug "engaged in business conduct or practice, which is unbecoming or detrimental to the public interest in that he had an undisclosed financial interest."

Lissaman says that while people are "very upset" about losing investments, they must be prepared to pay some of the costs involved in taking legal action against their advisors. Hiring outside experts to help assess the suitability of a case could cost as much as $1,000. And even if there's a contingency arrangement with a lawyer, the client will have to cover other disbursements, such as court transcripts, "because the law firm cannot be their bank," says Lissaman, who sometimes won't send someone a bill if, after reviewing their investment documents, believes there isn't a case for litigation.

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How to spot a good investment advisor

Over his 26-year career as a lawyer Peter Jervis has been involved in plenty of investment-dealer negligence cases, including *Varcoe v. Dean Witter Reynolds Inc.* (1992), 7 O.R. (3d) 204 (Gen. Div.), in which he acted for a sophisticated investor who lost a significant portfolio as a result of the negligence and breach of duty of his stockbroker. The decision, affirmed by the Ontario Court of Appeal (1992), 10 O.R. (3d) 574 (C.A.), established a new legal basis for stockbroker liability when brokerage industry standards and statutory and regulatory standards have been violated.

Good investment firms adhere to the KYC (know your client) rule promulgated by the Canadian Securities Institute and which is often referred to as the cardinal rule within the industry, explains Jervis, a partner in the national litigation group at Davis LLP in Toronto.

"When a client comes in and wants to open an account in order to trade in securities, the investment dealer — through the registered salesperson — has the duty to find out key information about the client's financial situation and liquid net worth, age, employment, income, dependents and investment objectives on an overall basis and for the particular account being invested."

The investment advisor is also required to ensure that the investment is suitable and appropriate for the client and is aligned with the investor's objectives — and not having, say, a 78-year-old widow speculating on stock index or currency futures, or buying options on gold mining stocks.

In turn, the client is meant to sign the document containing this information (though some investment firms don't always do that, says Jervis) and the licensed and registered investment or mutual fund dealer is obligated to use the document as a guide in supervising the account.

But the KYC and suitability rules "are often not honoured, especially when the markets are really, really good and everybody's getting a little too aggressive and greedy," and a client's objectives, which should have been "careful, safe and conservative," are changed by the broker to become "medium to high risk, and clients get exposed to far more risk than they can afford," says Jervis.

"A firm's compliance officers can only supervise based on what's in the documentation, which often gets computerized as code."

In “unfortunate situations, imprudent brokers” wanting to make a lot of money (for their clients and for themselves) get clients to double or triple up their investments by trading on margins. Jervis says that when markets fall, as they have going back to Black Monday 1987 (when he began handling investment-dealer negligence cases) and investors lose significant amounts of money, some brokers might not say, “I gave you bad advice, you’re significantly over-leveraged, let’s sell out when the market starts to turn. “They think it’s going to get better.”

Yet someone who lost half of a $1-million investment intended for retirement will contact Jervis and be desperate for a solution — a situation, he adds that “happens time and time again.”

However, he hastens to add that such sad stories don’t usually involve “reputable, bank-owned” investment dealers, but more often smaller firms pushing such products as hedge funds, which bear “massive” risks.

“The industry is supposed to run like medicine where a good medical professional talks about risk and obtains informed consent from a patient. But investing is sometimes like playing the blackjack table at Casino Rama — especially if people go to more aggressive financial professionals.”

Jervis says that while some of his clients — who work as options or commodities traders — have “more responsibility” to check for investment-related trouble, most people who come to him “can’t read their statements and have no idea what they mean.”