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Securities Class Action Lawsuits Against Wall Street Brokerages vs. Securities Arbitration Claims: A Study to Determine the Appropriate Path for Securities Dispute Resolution

With hundreds of filed class action lawsuits alleging stock brokerage firm misconduct pending today, millions of public and institutional investors must carefully weigh all options available to assist them in recovering their losses.

The Emergence of Arbitration as a Means of Securities Dispute Resolution

The landmark court case of *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed. 2d 185 (1987) was a milestone both for investors and the securities industry. In *Shearson*, the Court determined that the arbitration clause contained in a agreement between the client and the brokerage firm was valid and enforceable. As a result, securities disputes between customers and their brokerage firms were moved from the confines of the courtroom to arbitration forums, where the time and costs expended to obtain an award have been streamlined and significantly reduced. A review of studies and data collected over the past several years provides a perspective on the misconceptions between securities arbitration dispute resolution and securities class action litigation that still exist today.

Prior to the *Shearson* case, investors were saddled with expenditures of time and money to resolve their disputes in an already overburdened civil court system. Class action lawsuits have evolved as a cost-effective method for recovering losses suffered in the securities markets. To the unsophisticated investor, participating in a class action might seem like a simple method to recover securities-related losses, however; investors should note that until the court certifies the class, an investor stands alone and is not represented by legal counsel. Class action is appropriate only when the alleged wrongdoings arise from a set of facts and issues common to all class members.[1] By

[1] The Federal Rules of Civil Procedure, Rule 23 (a) Prerequisites to a Class Action states, "One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to

practicing in a class action, the investor-client who does not take on the lead-plaintiff status is automatically included in the class. Unless the investor opts-out, once the class is certified and settled the investor will receive a percentage of the settlement. More often than not, investors have failed to realize that participating in a class action precludes them from individual representation and the potential recovery through securities arbitration.

Factors Leading to Class Action Litigation

There are several factors that have led to the use of class action lawsuits as a vehicle to recover investor losses. A study by Cornerstone Research, titled *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2001*,[2] also available on the Stanford Law School Securities Clearinghouse website, noted the following major causes:

- Class Actions were filed when the firms failed to report earnings in accordance with Generally Accepted Accounting Principles (GAAP).
- Class Actions were filed as a result of damages sustained from insider trading activity.
- Class Actions were filed by investors involved in Initial Public Offerings and named the under-writer as a party for the purpose of funding any possible recovery.
- Class Action lawsuits were filed against companies in the Finance, Healthcare, Retail/Wholesale, Technology and Telecommunication industries. (For example, analyst conflict, drug side-effect, tobacco, and asbestos.)

Large Class Action Settlements Tend to Skew Average Recovery Rates

The Cornerstone Research study titled *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002,* found that as the alleged damages increases, the percentage recovery declined. Economies of scale do not work in the favor of plaintiffs who have suffered large losses. There have been five settlement in excess of $200 million dollars since the Private Securities Litigation Reform Act of 1995 was passed. These include Cendant Corporation's (CD) $3.525 billion payout, the Bank of America (BAC) litigation that settled for $490 million, two separate class actions settled by Waste Management, Inc., (WMI) for $457 million and $220 million respectively, and 3Com Corporation (COMS) which settled a class action for $259 million. Settlement amounts of the magnitude have acted to change the statistical methods used to analyze class action award and recovery rates. To determine the percentage of losses returned in class action settlements, past

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the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class."

[2]Both the 2001 and 2002 study are available in PDF format at Cornerstone Research http://www.cornerstone.com and at the Stanford University Law School website, http://securities.stanford.edu/, where Stanford University maintains the Securities Class Action Clearinghouse in cooperation with Cornerstone Research.

reports utilized the average settlement values of securities class actions, which is not an accurate measure. Newer studies rely on the median value of settlements, where the highest and lowest awards are not included in the calculations. The 2002 Cornerstone report indicates that for all reported Federal Circuit Court and State Court settlements, the median settlement amount paid to any individual investor participating in a class action was only 3.825% of that investor's estimated damages.

Of particular interest to investors is the fact that in the 2002 Cornerstone report, non-cash components constituted 60% of the median settlement value in class action cases included in the Cornerstone research. This means that as part of the settlement package for losses sustained on any particular stock, class action participants can expect to receive stock options and warrants, in lieu of cash, for the very products that were the basis of the class action suit. For example, Lucent Technologies (LU) recently settled a class action lawsuit by agreeing to pay investors $600 million; however, this number includes $315 million in common stock, cash or a combination of both, $200 million in Lucent-issued warrants to purchase shares of common stock using a strike price of $2.75 and a 3 year expiration term, an agreement by Lucent to pay up to $5 million for settlement administration costs, and agreements by certain Lucent insurers to pay $148 million in cash into the settlement fund. In addition, Lucent spin-off Avaya (AV) is to contribute $26.5 million in cash or stock, plus a percentage of the value of the warrants that will be issued.

The Real Statistics for Arbitration Awards

The downturn in the stock markets over the last three years has resulted in a record-high level of arbitration claims being filed at the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the American Arbitration Association (AAA), the primary forums for arbitration of securities-related disputes. A study completed by the U.S. General Accounting Office (GAO) in 1992 made the following findings:

- Investors receiving arbitration awards recouped an average of 61% of the amount of losses claimed.
- In approximately 30% of the disputes included in the study, arbitrators awarded investors the full amount of losses claimed.
- Investors whose cases were decided after an arbitration hearing were 1.4 times more likely to obtain an award than those cases decided without the benefit of a full hearing.
- While attorney representation did not effect whether an award was made, investors represented by attorneys were 1.6 times as likely to receive an award in excess of 60% of their claim.

A 1996 survey by the GAO found that the size of the claim in dispute has an impact on both the "win"

and "recovery" rates in filed arbitration cases. The report indicated that the recovery rate for winning claimants was a high of 82% of losses for the smallest claims, to a low of 24% of losses for the largest claims. This 24% loss recovery rate in arbitration is still significantly larger than the median return rate of 3.825% for losses recovered in class action litigation.

Summary statistics reported by the NASD show that investors filing claims in the NASD arbitration forum have, on the average, prevailed in their claims. This is borne out both by historical statistics from the years 1998 through 2002, and the year-to-date report through February 2003. Compiled below is a table that includes filed claims, by the year decided, the number of claims filed, and the number of cases where damages were awarded to customers.

Year Decided	Total Number of Cases Decided	Number of Cases Where Customers Were Awarded Damages	Customer Awards as a Percentage of Total Cases Decided
1998	1,573	937	60%
1999	1,148	697	61%
2000	1,396	734	53%
2001	1,365	725	53%
2002	1,483	820	55%
2003 YTD	245	143	58%

Statistical evidence shows that arbitration is fair to investors and provides a strong rebuttal to those who claim that the arbitration process is structurally biased in favor of the securities industry. Complete information for arbitration and mediation statistics is available on the NASD website located at (http://www.nasdr.com) .

Claims That Fare Best in Arbitration

Contrary to securities class actions where suits are based on one underlying stock, securities arbitrations are brought against broker/dealers and registered representatives for sales practice violations. These violations include over-concentration in a single stock or market sector, such as technology and telecommunications; excessive use of margin; unauthorized transactions; excessive account activity; and the unsuitable allocation between stocks and bonds. A classic example of a case that is appropriate for securities arbitration is an investor who loses money based on sales practice violations, rather than losses based on fraudulent representations of the company issuing the stock.

Consider Using Arbitration When Your Losses Exceed $100,000

Arbitration as an alternative path will ultimately depend on whether the alleged losses are a result of sales practice violations and whether the alleged damages are large enough to justify the mid-four figure costs required to retain competent legal and expert advice. Because statistics for investors suffering large losses reveal an overall lower recovery rate in class actions, those investors should strongly consider using arbitration as a means of recovering losses instead of participating in a class action.

The actions of institutional investors, such as the University of California, ("UC") support the results of these studies. Most recently UC withdrew from the pending class action filed against a prominent brokerage firm and WorldCom, Inc. (WCOEQ.PK) and instead, filed an individual action. UC's losses in connection with its WorldCom stock holdings were in excess of $353 million. Similarly, UC has also chosen not to participate in a federal class action suit filed against AOL Time Warner (AOL), its accounting firm, and several prominent brokerage firms, again seeking recovery outside of the class action because its losses are so extensive. UC has reportedly lost $450 million on its AOL Time Warner investment.

Some of the more familiar investment opportunities of the recent past that have resulted in class action litigation against Wall Street brokerage houses include:

24/7 Real Media, Inc. (TFSM); Aether Systems (AETH); Agilent Technologies, Inc. (A); Allied Riser Communications Corp., (ARCC) now known as Cogent Communications Corporation, Inc. (COI); Ask Jeeves Inc. (ASKJ); AT&T (T); AT&T Wireless Services (AWE); CMGI, Inc. (CMGI); Covad Communications Group, Inc. (COVD.OB); Enron Corp. (ENRNQ.PK); e-Toys Inc. Now known as EBCI, Inc. (ETYS.PK); Excite at Home Corporation (ATHMQ.PK); Global Crossing, Ltd. (GBLXQ.PK); Ivillage, Inc. (IVIL); Infospace, Inc. (INSP); Interliant, Inc. (INIT.OB); Internet Capital Group, Inc. (ICGE); Level 3 Communications, Inc. (LVLT); Merrill Lynch Internet HOLDRs (HHH); Merrill Lynch B2B Internet HOLDRs (BHH); Merrill Lynch Focus 20 Fund (MAFOX, MBFOX); Merrill Lynch Internet Strategies Fund which was merged with Merrill Lynch Global Technology Fund (MAGTX, MBGTX); Merrill Lynch Internet Infrastructure HOLDRS/SM Trust (IIH); Metromedia Fiber Network, Inc. (MFNXQ.PK); Morgan Stanley Dean Witter Technology Fund (TEKAX, TEKBX); Openwave Systems Inc. (OPWV); Pets.com, Inc. (IPETZ.PK); Qualcomm, Inc. (QCOM); Quokka Sports, Inc. (QKKAQ.PK); Razorfish, Inc. (RAZF); Rythms NetConnections, Inc. (RTHMQ.PK); Winstar Communications, Inc. (WCIIO.PK, WCIIP.PK); and XO Communications, Inc (XOXOQ.OB).

Investors who have losses in excess of $100,000 in these stocks or funds should consider pursuing their damage claims against their brokerage firm through arbitration.

Mediation as an Alternative Path for Dispute Resolution

Mediation is an alternative path open to individuals who have filed an arbitration claim in a Self-Regulatory Organization (SRO) forum, such as the NASD, the NYSE, or the AAA. Unlike the adversarial proceedings of class action litigation or arbitration, the parties must consent to the

mediation process. Losses suffered by an investor are established by mutual agreement based on each party's evidence, and the amount of any payment made to reimburse a loss is also by mutual agreement. While using the mediation process increases the likelihood of reaching a mutual agreement, the possibility that the agreed-upon amount could be different from an award or finding by an arbitration panel must be considered.

Conclusion

In conclusion, investors must make informed decisions about which litigation path is appropriate for them. Empirical evidence shows that when an investor suffers losses in larger amounts, usually in excess of $100,000, an individual dispute resolution process such as an arbitration claim filed in the appropriate SRO forum, is best means of recovering losses suffered. Any investor suffering a loss as a result of over-concentration in a market sector or a single stock, excessive use of margin, excessive account activity, unauthorized transactions, or the unsuitable allocation of investor assets between stocks and bonds, should consult with competent legal counsel to review all recovery options available.