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Securities Arbitration Alert

Recovery Rates Survey

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ON RECOVERY RATES: *A few years ago, the head of NASD Dispute Resolution, Linda D. Fienberg, was quoted in the press as she remarked upon a \$1 billion claim that had been filed with the forum; what would you say to a single customer claim for \$75 trillion?* Of course, we have heard nothing about that claim in the media and NASD-DR did not herald its filing. Why -- because it is indisputably an outrageous amount. The \$1 billion claim may have been an outrageous amount, too, we cannot say, but we do know that this *pro se* claim was not deemed compensable by the New Orleans-based Panel that considered it (*Garth v. TraderMart*, NASD ID #04-06706, 9/15/05). The *Garth* case went one hearing session before the parties agreed to allow the Arbitrators to decide the case on motion. The \$75 trillion claim met a similar fate, but there the Claimant, again a *pro se*, did not even reach the hearing room. The Panel granted a pre-hearing motion to dismiss (*Sills v. SunTrust Inv.*, NASD ID #05-03262, Richmond, 5/22/06).

Claim Inflation: The aggregate amounts claimed in Customer-Member cases (i.e., customer-initiated claims over \$25,000) have been rising steadily during the new Millennium. In 2000, there were 1,014 Customer-Member Awards issued, according to SAC's Award Database, with an approximate claim total of \$508 million. The number of Awards issued in 2005 doubled (mainly because of the prevalence of Stipulated Awards), but the aggregate claim amount soared more than twelve-fold to \$6.3 billion. We included the *Garth* Award in that calculation and another Award in which the Claimant requested \$835 million in claimed losses. The latter case, *Sturm v. Citigroup Global Markets*, NASD ID #03-07612 (Denver, 11/30/05), reportedly did involve actual losses in that amount by a single individual. Moreover, the case was fully tried on its merits (32 hearing sessions) by competent counsel on each side. Claimant ultimately lost and is currently pursuing a post-Award bias claim, according to a recent New York Times article that highlighted the case.

Very Large Claims, 2005: There were nine Customer-Member Awards deciding claims of \$100 million or more in 2005, only one in 2004, and a total of two in the four earlier years. We know, from speaking with counsel in several of those 2005 cases, that the damages were not grossly inflated, but in many instances the tendency to inflate damage claims is plain. It is plain, because the awards accorded Claimants in those \$100 Million-plus cases that prevailed are dwarfed by the amounts as to which liability was claimed.

One huge award in 2005, *Visconsi v. Cowen & Co.* (\$10.4 million), aptly illustrates this point. In *Visconsi* (#03-07606), a total claim of \$338 million erroneously suggests that

the Claimants received only about 3% of their losses. In fact, the *Visconsi* Claimants were satisfied enough with that award amount to defend it (successfully) in a subsequent court challenge by one of the broker-dealers. These distortions from exaggerated claims have consequences that are inimical to securities arbitration. Mainly, they adversely impact recovery rate calculations and recovery rates, along with “win” rates, have become key components of measuring SRO arbitration’s success in providing fair forums.

Recovery Rate Reliability: While calculating “win” rates is a relatively straightforward exercise and one that yields a fairly reliable statistic, calculating recovery rates for customers presents greater complexity and more subjectivity and yields a more volatile (and hence less reliable) statistic. In fact, some of the SRO forums publish “win” rates before their forum’s arbitrators, but none supplies recovery-rate statistics. SAC is in a position to provide recovery-rate statistics and we have, throughout the years, because we believe that, despite its frailties, such statistical information supplies important intelligence to parties and arbitration practitioners. People use win-rate and recovery-rate statistics to make strategic choices about pursuing and resolving their disputes. . It answers the second most-often-asked question by arbitration skeptics: “Even if customers win a fair percentage of the time, *just how much do they win?*” Justifying arbitration, at least to those without the benefit of empirical observations, requires that an answer to this second question be attempted.

Consequential Damage: Exaggerated claims frustrate this effort as one can see by calculating an average recovery rate for 2006 Customer-Member Awards without the \$75 trillion *Sills* claim (approx. 24%) and calculating such a rate while including the *Sills* Award (far less than 1%). One Claimant’s lawyer we know has used New York City’s consistently poor showing, relative to other SRO hearing locations, to challenge the obligation to arbitrate in court. *Newsday*, the Long Island newspaper, has based a major story around New York City’s statistical distinction and the New York Attorney General’s Office has even made inquiry on the subject. People make important choices and draw critical conclusions based upon recovery-rate figures and the consequences will be significant should they lose reliability.

What Can Be Done? Is it too much to expect that claiming parties and their lawyers will moderate their claims in order to serve the goal of higher-quality statistics?

Exaggerated claims result from some perception – however ill-conceived – that a higher claim amount advances the Claimant tactically. Most Claimant’s lawyers, we think, would not subscribe to the notion that grossly exaggerated claims provide an advantage, but a greater number would say that the negatives of doing so do not clearly condemn the practice. Practical disincentives may be the most effective manner in which to control claim exaggeration. Forum fee determinations are aided by a specific claim estimate, because the SRO forums charge fees on a sliding claim scale. A number of years back, the SRO forums raised the fees for unspecified claims in order to encourage Claimants to state a dollar figure in their claim filing. We think therein lies an answer.

Using Fees to Encourage Accuracy: Unfortunately, the current Schedule of Fees tops out at \$10 million, so a \$100 million claimant files as cheaply as a \$10 million claim does. Worse, under the proposed Customer Code, the Schedule of Fees for customer disputes tops out at \$1 million. No disincentive will exist to encourage reasonable damage estimates, once the \$1 million threshold is breached, yet the adverse

consequences of numerous highly exaggerated claims will range well beyond the individual cases in which they are made. A percentage surcharge would be our fix, but, even if it's a higher stepladder or another method, the use of filing fees to encourage reasonable approximations on high-dollar claims would foster accuracy, while impacting a small group of claimants. That group would also seem most unlikely to fall into that protected class to whom higher fees would present a barrier to vindicating statutory securities claims. *(ed: These are our thoughts and ideas on recovery rates. We welcome messages from subscribers agreeing or disagreeing with this short essay – or making other suggestions than ours.)* (SAC Ref. No. SAA 2006-25, 6/21/06)