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Investor Wins Record $16.5M In Securities Arbitration

By Paul D. Boynton

Small-Firm Victory

A self-made Belgian millionaire recently obtained what is believed to be a record-setting securities arbitration award of $16.5 million – including an unprecedented $12.4 million in punitive damages.

Experts tell Lawyers Weekly USA that the award signals a growing willingness on the part of securities arbitration panels – long viewed as biased in favor of the financial industry – to punish egregious misbehavior by brokers and brokerage firms following the collapse of the high-tech stock market.

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The Jan. 24 arbitration award from North Carolina featured broker fraud and theft, as well as lax supervision by the brokerage firm and a subsequent cover-up.

The brokerage firm then made a tactical error by fighting liability aggressively and producing records only grudgingly, said plaintiff's attorney David S. Rudolf, who practices in a four-lawyer firm in Chapel Hill, N.C.

The brokerage firm, Wachovia Corp., "created almost an aura of bad faith" during the arbitration proceeding, Rudolf said.

The arbitration panel issued a lengthy opinion, which is noteworthy because written securities arbitration awards are rare, according to

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industry observer Douglas J. Schulz of Westcliffe, Colo.

The National Association of Securities Dealers, which handles about 90 percent of the securities arbitrations in the country, is currently facing a spike in case filings – from garden-variety churning cases to novel claims based on the failure of brokerages to disclose stock-research conflicts.

As these cases work their way through the pipeline, experts say higher awards and more punitive damages can be expected.

Schulz said "the fear was that [arbitration] panels would view the downturn in the stock market as a situation where everyone simply lost money. But just the opposite is happening. Panels are awarding investors more and more of the money they lost, when in the past it was rare for investors to be made whole."

Schulz, the author of "Brokerage Fraud: What Wall Street Doesn't Want You To Know," said brokerage firms have lost credibility in light of widespread media reports of fraudulent and reckless conduct, and that has heightened the skepticism of arbitrators.

Diane A. Nygaard, a veteran Kansas City, Mo. securities attorney, said arbitrators are exhibiting "more sympathy toward investors and less toward the industry."

Fostering that view, said Nygaard, is a growing number of cases involving "horrifying conduct of young brokers without any supervision who only knew a bull market. They were entrusted with the money of individual investors, many of whom were inexperienced and unsophisticated. Just to generate commissions, [these brokers] invested those accounts in risky investments on margin, incurring interest on the loans, when a more balanced, conservative approach was appropriate."

The larger awards also reflect the fact that greater amounts of money were lost by a wider spectrum of individual investors than in the past, said San Francisco attorney Cary S. Lapidus, who last fall obtained back-to-back awards of $1.7 million and $1.4 million.

"Just a couple of years ago, you'd rarely see seven-figure awards, but we're seeing a geometric increase over the last two years," Lapidus said. "And there will be more large awards because the wrongdoing that occurred during the height of the market is now being uncovered and exposed. People lost a lot of money."

For example, he noted, many high-tech employees, flush with lucrative stock options, invested with brokerages expecting capital preservation and wealth management, but instead suffered devastating losses in risky high-tech and Internet stocks.

NASD statistics show that of the approximate 1,500 cases decided in 2002, 55 percent resulted in awards to investors, compared to 53 percent in 2000 and 2001. The total amount awarded in 2002 (compensatory and punitive damages) was about $139 million, a 43 percent increase from 2001 and almost double 2000's total.

Mass tort attorneys are now venturing into this field, aggressively seeking out claims as Wall Street braces for a stampede of investor suits.

Orlando, Fla., attorney James R. Hooper, who first rose to prominence in breast-implant and fen-phen cases, is running a million-dollar ad campaign for new clients. He and his colleagues are "recruiting plaintiffs' lawyers in every state in the U.S. who have an interest in pursuing these cases."

Hooper and others are focusing on investor claims that prominent Wall Street stock analysts like Jack Grubman and Henry Blodget deceived them by issuing overly optimistic research reports on companies such as WorldCom, Inc., primarily to win investment-banking business for their companies.

Hooper and other attorneys are hoping to take advantage of findings in a case against Merrill Lynch & Co., Citigroup Inc.'s Salomon Smith Barney and others which led to a recent $1.4 billion settlement with regulators over conflict of interest charges.

The government has released damaging e-mails showing analysts were pressured by investment bankers to issue glowing research reports, and that they didn't always think the stocks they were recommending were as good as promoted.

Shell Game

In the North Carolina case, Belgian millionaire L. R. Castelein decided to park $12.5 million in what he believed was an account maintained by well-known securities firm Bear Stearns Cos., with the money to be invested in a treasury bill with a 7.1 percent return. The account was to be used as collateral for other possible transactions that only Castelein would authorize, but the principal was to remain untouched.

Instead, the broker, Douglas Reid, "flat out stole money from the account," according to Rudolf, by trading heavily for high-commission fees and wiring money to third parties for dubious investments. Reid forged Castelein's signature to gain control of the money.

Reid also falsely represented himself as a Bear Stearns employee, using Bear Stearns business cards and stationary with his name on it. In fact, the firm only processed trades on behalf of Reid and his real employer, Corporate Securities Group Inc., the predecessor to Wachovia.

To facilitate the fraud, Reid created false statements to hide the unauthorized transactions and to show false amounts of money in the account.

According to Rudolf, Reid's employer essentially looked the other way because he was producing big profits. The arbitration panel found that because the employer failed to follow its own procedures for supervising accounts, it was jointly and severally liable for the total award.

"There was no quality control whatsoever," Rudolf said. "[Corporate Securities] was only interested in how much in commissions it would earn."

The arbitrators also ruled that Bear Stearns was responsible for $200,000 of the award because of its shoddy oversight of wire transfers.

Defense attorney David G. Russell of Atlanta declined to comment on the case.

Leveraging Information

Last year, Reid pleaded guilty to money laundering and fraud charges in connection with his handling of the Castelein account and others.

Rudolf, normally a white-collar defense attorney, said he drew on his criminal law background to pressure Reid into providing useful testimony in the civil case. Rudolf contacted the FBI and U.S. Attorney's Office and presented a package of documents to show how Reid had committed fraud against his client. This information helped prosecutors, who in turn pressured Reid to help Castelein get his money back in the securities arbitration case.

"When he realized he was about to get hammered by the federal government, Reid decided to cooperate with us [as part of a plea bargain]," Rudolf said. "He provided us with a detailed affidavit of exactly what he had done. I took the information I had and used it effectively to create leverage for my client."

Being new to securities arbitration, Rudolf said he was unconcerned about what was considered standard procedure.

"I was very aggressive in pursuing discovery," he said. "I wasn't worried if that wasn't normally done. I kept asking for documents that might help me, and I believe the panel started to share the feeling that documents were being withheld. They ordered Wachovia to produce quite a few documents, many of which were useful and weren't produced until the hearing."

One such document helped impeach Wachovia's former director of compliance, who had testified that the company had never been censured by the NASD for lax supervision. Rudolf obtained a prior censure, which forced Wachovia's attorney to announce to the arbitrators that the witness had perjured herself.

"At that moment, it became clear that they were going to award punitives," Rudolf said. "After that, it was all icing on the cake."

Schulz said discovery abuse is common in these cases.

"Arbitrators have been so namby-pamby. They usually don't order brokerage firms to produce documents, and don't sanction them," he asserted.

But that may be changing, Nygaard said.

"If companies destroy documents or don't produce them, that may lead to punitive damages," she said, "because panels may see that as wasting their time and obstructing justice."

Rudolf said he believes another key to the high award was treating the proceeding like a trial to create a certain formality – from standing during his arguments to setting up counsel tables and a witness stand.

"I wanted the arbitrators to feel like this was a serious proceeding with important issues to be decided, as opposed to people sitting around a table in a hotel conference room talking about it. It seems to me that because my client was asking for millions of dollars, we needed a more solemn atmosphere," Rudolf said.

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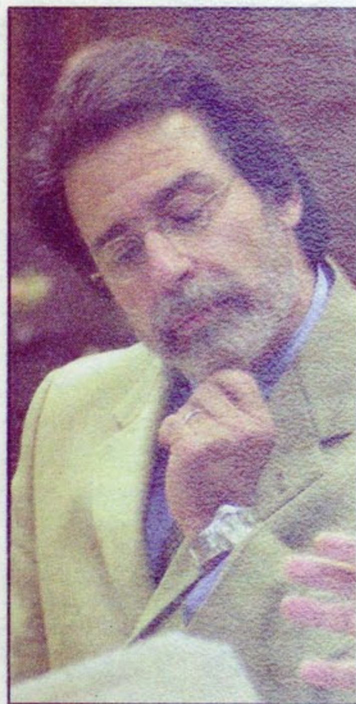

AP Photo/The Herald-Sun, Sara Davis

Low-Ball Offers

Brokerage firms historically have not offered anywhere close to the full value of losses in settlement talks because of the perception that arbitrators rarely award full compensation, according to Schulz.

That's partly due to the fact that many arbitration panels function more as mediators seeking an equitable settlement, said Schulz.

Rudolf said he openly confronted this conventional wisdom, telling the panel he was seeking a large punitive damages award.

"I told them it was inconceivable that the [defendants] were denying liability, and that this case was about punitive damages," he recalled. "I said the industry is comfortable not making a full offer because it believes that's the worst arbitration panels will award, and they hope in the meantime to wear down opponents and offer 50 cents on the dollar."

Rudolf said he implored the panel not to sanction this tactic. "I wanted to motivate them to do something far beyond what a typical NASD panel does."

Historically, he said, "brokerage firms have engaged in delay and obfuscation to beat their clients into submission and then pay a fraction of a loss. That's the way the system has come to function. Coming at it from my perspective as a newcomer to this area, that was unacceptable to me."

Lapidus, however, struck a note of caution on punitive damages.

In his back-to-back million-dollar-plus cases from last fall, he was unable to persuade the arbitrators to punish the brokers and brokerage firms despite evidence of fraud.

"That just goes to show that arbitrators are reluctant to award punitive damages," he said.

Cases more ripe for punitives might include those involving blatant misrepresentations of what brokerage firms thought of the merits of the stock they were urging clients to buy, Lapidus said. But negligence cases involving brokers who failed to adhere to fundamental investment principles in the high-tech frenzy are not likely candidates.

Plaintiff's attorney: David S. Rudolf of Rudolf, Maher, Widenhouse & Fialko in Chapel Hill, N.C.

Defense attorney: David G. Russell of Parker, Hudson, Rainer & Dobbs in Atlanta.

The Case: *Castelein v. Bear Stearns & Co.*; National Association of Securities Dealers Arbitration Case No. 99-04213; Charlotte, N.C. LWUSA

Questions or comments can be directed to the writer at: pboynton@lawyersweekly.com

Get The Decision

You can read or print a copy of the arbitration panel's written decision in the "Important Documents" section of Lawyers Weekly USA's Internet site:

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