



Expanding Liability For Financial Professionals

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Generally, financial services professionals are more likely to be found liable for losses in a customer's account when the account is discretionary. While the traditional distinction between discretionary and non-discretionary accounts still stands, attorneys have recently started to assert claims premised on a hybrid account/relationship that gives rise to certain fiduciary duties. The hybrid relationship is important because it has the potential to significantly expand the scope of potential liability for financial services professionals.

Three Kinds Of Accounts

The relationship between a broker and his or her customer varies between (1) discretionary; (2) non-discretionary; and, more recently, (3) something in between. *Vestax Securities Corp. v. Desmond*, 919 F.Supp. 1061, 1072 (E.D. Mi. 1995). See also *Leib v. Merrill Lynch*, 461 F.Supp. 951 (E.D. Mich. 1978).

Discretionary Accounts

In a discretionary account, the broker DOES NOT need customer authorization before making a transaction, and has a fiduciary relationship with the customer.¹ *Id.* Courts have outlined the duties of a financial services professional in regards a discretionary account to include the following:

- The duty to manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history;
- The duty to keep informed regarding the changes in the market which affect the customer's interest and act responsively to protect those interests;
- The duty to keep customers informed as to each completed transaction; and
- The duty to explain forthrightly the practical impact and potential risks or the course of dealing in which

the broker is engaged.

See *Leib*, supra, 461 F.Supp. at 953.

Non-Discretionary Accounts

In a non-discretionary account, the customer, rather than the broker, determines which purchases and sales to make and NO fiduciary relationship arises. *Id.* Courts have articulated 6 duties associated with non-discretionary accounts:

- The duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis;
- The duty to inform the customer of the risks involved in purchasing or selling a particular security;
- The duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests;
- The duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security;
- The duty not to misrepresent any fact material to the transaction; and
- The duty to transact business only after receiving prior authorization from the customer.

See *Leib*, supra, 461 F.Supp. at 953.

Hybrid Relationships

In between the above two accounts is a third kind of "hybrid account" where the broker has taken actual control over a technically non-discretionary account. When this happens, courts have found that the broker owes the customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation. *Id.*

Attorneys for claimants have been using this argument with increasing frequency in the last few years. It seems to be an effective argument because it creates

enhanced responsibilities for the broker in regards to the investments of his or her former clients.

Reasons Why The Hybrid Relationship Is Important – EXPANDED LIABILITY

The most significant impact of the finding of a hybrid relationship by a court or a FINRA arbitration panel lies with the fact that it exponentially expands the scope of liability for financial services professionals. That is, it essentially means the professional is damned if he/she does, damned if he/she does not. More specifically, in a non-discretionary account, the authorization papers usually PRECLUDE the professional from taking unauthorized actions. Discretionary accounts allow the professional to take these actions. But in the event that a hybrid relationship is found, the professional would not technically have had the authority to take the actions that the hybrid relationship demands. So, the professional arguably could face exposure for taking unauthorized actions on the one hand, while also theoretically facing exposure for breaches of fiduciary duty for failing to take said actions on the other.

How To Determine Whether A Hybrid Relationship Has Arisen

Courts, and the FINRA panels which have accepted the approach of the courts, have analyzed the following to ascertain whether a hybrid relationship has occurred:

- The age, education, intelligence, and investment experience of the customer;
- If the broker was socially or personally involved with the customer; and
- If prior transactions occurred WITHOUT the customer's prior approval.

The above factors often form the basis for finding a hybrid relationship between the broker and his or her client. As for responding to the above-elements if plead in a statement of claim or court complaint, at least one court had concluded that the analysis of whether a hybrid relationship exists is necessarily a fact-intensive one that is "best not" decided on the pleadings. *Dow Corning Corp. v. BB&T Corp.*, 2010 WL 4860354, *16 (D.N.J. November 23, 2010). Thus, to the extent that the hybrid relationship is alleged in

court, it may be difficult to attack vis-à-vis a dispositive motion. Since dispositive motions are now disfavored in FINRA arbitrations, the likelihood of attacking the hybrid relationship is also slim.

Ways To Undermine The Finding Of A Hybrid Relationship

On the other hand, courts often simultaneously examine other factors to determine whether a hybrid relationship occurred, including analyzing whether the broker and the customer spoke frequently about the status of the account(s) and investments. If the customer and broker spoke frequently, this can be used to demonstrate that the customer maintained control over the account. In addition, if the customer was well-versed in finance and the world of investments, it will be more difficult to argue that a hybrid relationship developed.

Adoption Of A Uniform Fiduciary Standard

In January of 2011, the Securities and Exchange Commission recommended the adoption of a uniform fiduciary duty standard for those who provide personalized investment advice about securities to retail customers. This standard would appear to supplant the suitability standard in that it would apply to persons other than registered investment advisors who were already subject to fiduciary duty strictures. Since that time, there have been lengthy arguments within the securities industry over the viability and propriety of implementing such a uniform standard. What some have noted is that, as discussed above, courts and arbitration panels already have the ability to apply such a standard vis-à-vis the hybrid relationship recognized by courts, in among other cases, *Vestax Securities Corp. v. Desmond*, 919 F.Supp. 1061, 1072 (E.D. Mi. 1995) and *Leib v. Merrill Lynch*, 461 F.Supp. 951 (E.D. Mich. 1978). Because such a standard has already been recognized, it may mean that the industry either does not implement the uniform standard or waters it down so that it does not rise to the level of the fiduciary duties owed to customers by registered investment advisors.

1. While FINRA and the industry are discussing the adoption of a uniform fiduciary standard, no such standard has yet been adopted. This issue is discussed in greater detail infra.

About Jeff Hines

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Mr. Hines joined the firm as a partner in 2003. He was formerly the managing principal of a regional law firm's District of Columbia and Virginia offices. Mr. Hines is licensed in Maryland, the District of Columbia and Virginia, and has represented clients in trials and appeals in all three jurisdictions. His areas of practice include professional malpractice, toxic tort and environmental, pharmaceutical, products liability, and commercial, securities and employee litigation. Mr. Hines is listed in Best Lawyers in America under legal malpractice law and product liability litigation, in Super Lawyers under products liability and in The Best of the U.S. Mr. Hines was named the Best Lawyers' 2012 Baltimore Legal Malpractice Law – Defendants' Lawyer of the Year.

Commercial, Securities and Employee Litigation

In 2010, Mr. Hines tried a multimillion dollar case in the United States Bankruptcy Court for the District of Delaware. In 2009, Mr. Hines tried a three week case in the United States Bankruptcy Court for the Eastern District of Virginia arising out of the sale of an Alabama radio station. Mr. Hines is currently defending broker-dealers in cases filed with the FINRA. Mr. Hines prepares responses to the FINRA's Enforcement Department and defends broker-dealers and registered representatives in Rule 8210 examinations and in customer initiated arbitrations. In December 2004, after a three day arbitration, Mr. Hines obtained a defense verdict on behalf of a broker-dealer and registered representative, including an expungement directive. For over ten years, Mr. Hines was national counsel for Parents Without Partners, Inc., the largest single parent organization in the world whose members at one time exceeded 250,000. In his capacity as national counsel, Mr. Hines attended all board of director meetings and served on the executive committee. Mr. Hines handled employment claims, prepared all corporate filings, dealt directly with the Internal Revenue Service on 501(c)(3) issues, advised the board as to its duties and responsibilities and prepared or reviewed all contracts. Mr. Hines also lectured throughout the United States at local chapters regarding their legal and ethical obligations and assisted local counsel in the defense of claims filed against the corporation. Mr. Hines also represents corporations regarding compliance with ethical obligations.

Education

- University of Maryland School of Law (J.D., with Honors, 1985)
- University of Maryland (B.S., Economics, 1981)