The Impact of the COVID-19 Crisis on Financial Services Claims

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May 18, 2020

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The COVID-19 crisis is going to have a long-lasting impact on American society, business and our way of life. These long-term trends are difficult to predict, and the news and information about the COVID-19 virus continues to change on a daily basis. What is clear at this point, however, is that there have been significant losses in equities markets and across large segments of the economy. Despite the rapidly evolving situation, it is starting to become clear what type of retail investment products investors may have suffered losses on and what type of legal claims and litigation strategies PIABA attorneys plan to use going forward. Although firms and advisors now find themselves in a difficult situation, there are steps that can be taken to identify and mitigate potential litigation risks.

Pitches From PIABA Attorneys

The substantial decline in equities markets will likely result in pure market loss claims – which have not been seen for a long time given how strong markets have been. There will be claims that investors – and particularly senior investors – were too exposed to market risk. There will be standard suitability claims, over-allocation claims and claims that firms should have seen things coming. The well-managed portfolio theory of damages which PIABA attorneys have invoked over the last decade has now been seriously called into question, but PIABA attorneys will find new and clever ways to assert claims for damages.

In fact, firms can look at the websites of PIABA attorneys and see (in their own words) the types of claims they plan on asserting. The following four 'pitches' have been paraphrased from the website of a nationally-recognized PIABA attorney: Pitch #1: In the case of the recent stock market crash, fears over the coronavirus have been public for several months now. Pitch #2: It is reasonable to expect your financial advisor to have taken measures to protect your portfolio, and especially concentrated or large investments, against the market losses we are seeing now. Pitch #3: Sometimes customers are concentrated in one or too few investments (like a single stock) or in just one industry or sector (like too much in oil related stocks.) Pitch #4: Sometimes investors are stuck in one or more illiquid investments (like limited partnerships, private placements, promissory notes or private bonds) which put them at greater risk for outsized losses.

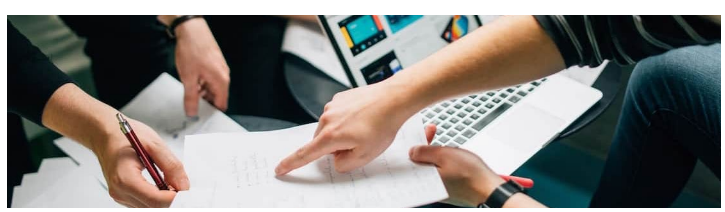
Anticipated Claims

There are sure to be claims regarding real-estate related investments – and this sector of the economy has clearly been effected by the fall-out from the COVID-19 crisis. Many tenants are now unable to pay rent, landlords are unable to pay mortgages and there is a real risk that property values could plummet. Construction projects are drying up and the future looks uncertain for many real-estate developers. Non-traded REITs, many of which had already encountered issues prior to the COVID-19 crisis, are anticipated to be the subject of new claims. Declines in NAV values and the suspension of cash distributions and share redemption programs in reaction to underlying problems in the real-estate market could trigger new claims. Publicly traded real-estate REITs, including mortgage REITs and funds with mortgage-backed securities, may also suffer significant declines in value and become the subject of claims.

PIABA attorneys are already claiming that the current problems in the oil and gas market were 'foreseeable' and are specifically marketing their pitches to potential claimants who lost money on oil and gas investments. The oil and gas sector was already encountering significant problems before the outbreak of the COVID-19 virus and the current crisis is now compounding these problems. With domestic and international travel at a fraction of pre-crisis levels, the problems associated with an over-supply of oil and gas have grown worse. Oil and gas prices have plummeted and, as of April 21, 2014, oil futures went down to negative $37 a barrel. It is expensive and difficult for many oil rigs to reduce or stop production, so oil has continued to be produced while companies struggle to figure out where to even store it. As such, firms can anticipate claims on a wide variety of oil and gas investments – including alternative investments.

Firms should also anticipate claims on a variety of illiquid investments. Claims tend to get filed when a customer loses a job or suffers another decline in financial circumstance – and then becomes frustrated when they are unable to access money needed from an investment. Firms need to be aware that many of their customers may have lost their jobs and/or small businesses and may ask to liquidate portions of their investment portfolio to provide for day-to-day needs. Certain of these customers will react poorly to being told that their investments are illiquid and either cannot be accessed at all or that a penalty must be paid. As such, firms can anticipate claims on alternative investments (like non-traded REITs or Reg. D private placements) and on annuities.

Variable annuities, of course, are somewhat of a mixed bag - since most variable annuities have exposure to the market and may have declined during the crisis. On the other hand, certain variable annuities offer guaranteed income riders and other guaranteed features which may seem much more attractive these days. Firms and advisors should be prepared to field questions from their customers about how to access funds in variable annuities. Annuity companies, for example, may be offering special conditions to make withdrawals easier during the COVID-19 crisis. However, firms and advisors need to have conversations with clients about the effects of any withdrawals - including the danger that losses will be locked in while markets are down.



PIABA attorneys are already suggesting that customers should assert claims based upon the improper use of margin during the COVID-19 crisis. As many customer accounts decline in value along with the general market, customers who were using margin face a heightened risk of margin calls. Firms should anticipate claims that margin calls forced customers to sell securities at rock-bottom prices to meet the calls. Customers will claim that the use of margin in their accounts was unsuitably risky from the start and that margin should never have been used based on the customer's ability and willingness to take on risk.

Firms should also anticipate claims in the following areas. First, investments which trade on volatility. For example, certain mutual funds employ options trading strategies which can produce steady returns when markets are stable but which can become incredibly risky when markets are volatile. A number of these mutual funds, which had been touted as conservative funds, collapsed under the weight of margin calls in February 2018 after a sudden and unexpected spike in the VIX volatility index.

Second, there are sector-specific investments – like those with exposure to the travel industry, the hospital industry, international trade and/or developing markets – which have suffered significant losses in recent weeks and whose future may be uncertain. The risks of losses and related lawsuits are compounded when customers have concentrated positions in these types of investments.

Third, firms and advisors face potential exposure for losses in actively managed accounts. Many advisors at independent firms use their own proprietary trading models to conduct discretionary trading in customer accounts – and these advisors are at a heightened risk of claims when there are trading losses related to declines in the general market or declines in specific sectors. In contrast, it may be harder for customers to assert these types of claims against advisors who utilize well-respected and widely-used third party money managers – especially when the advisory accounts were well-diversified at the time of the losses.

Fourth, PIABA attorneys are suggesting that customers assert claims for 'failure to execute' based on the general idea that customers may have told their advisors (before the current financial crisis) that they did not want to be in risky investments – and that since the current crisis was foreseeable, their advisors were under a duty to act and pro-actively re-allocate their accounts into more conservative investments.

There will also likely be claims that firms could not execute specific customer trade orders in a timely manner because they were understaffed during the first several weeks of the crisis – and that these delays in processing securities transactions caused losses. Finally, the compliance challenges associated with supervising representatives and advisors who work remotely (on this type of scale) are significant - and PIABA attorneys are sure to assert related failure to supervise claims.

Mitigating Risk

Articles are already starting to emerge about independent broker-dealers pausing the sale of non-traded REITs and other real-estate products while markets absorb the shock of the fallout from the COVID-19 crisis. Many firms, however, have already sold large amounts of non-traded REITs and other alternative and/or illiquid investments – and there is no obvious way for firms to divest themselves of these positions. After all, many such investments are unable to be sold, liquidated or redeemed at all – and even if some of these options were available, any such decisions would have to be based upon discussions with individual customers about what they feel comfortable doing. There are no easy choices here – and the risk/reward landscape has changed so dramatically in recent weeks that it is hard to know what to do. There are, however, some specific steps that firms can take going forward to mitigate the risk of customer claims.

First, firms, registered representatives and advisors should run profit and loss reports to identify those customers with the biggest losses and start contacting those customers first. It is important to remember that customers are going to have lost money and are going to be emotional. Customers may be inclined to blame their advisor or firm for these losses, and may be even more inclined to do so if they do not receive any type of communication from the firm or advisor. Firms and advisors need to talk to these customers about what has happened. These calls will not be easy, but should be appreciated. Firms and advisors, of course, need to be careful when communicating with customers about their losses. Firms and advisors need to be careful not to make any admissions which (in hindsight) might imply culpability or liability – and more generally be aware that written communications with customers may end up being exchanged as part of the discovery process in a lawsuit.

Second, even with customers who have not suffered substantial losses, now is still a good time to reach out and talk about what is going on. Talk to customers about any changes in their financial situation and document any changes in their investment objectives and risk tolerance. It is important to talk to customers about what they feel comfortable doing and document these discussions. It is especially important to talk to customers about their illiquid investment positions, whether customers need some or all of these funds and what, if anything, can be done to access these funds. There may not be a 'right' answer, but having these conversations is a good way to avoid customers feeling left in the dark on these issues, to mitigate the risk of a lawsuit being filed and to bolster potential defenses down the road if a lawsuit does get filed.

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Third, firms and advisors should run concentration reports to get a better understanding of where their potential exposure to litigation exists. Does the advisor/firm have large positions in oil and gas investments, non-traded REITs or alternative investments with exposure to the travel or hospitality sector? Firms should also review their E&O policies to understand which products are covered and which are not.

Finally, now is the time for firms to update their business continuity plans ("BCPs") to ensure that the firm can adequately function during the COVID-19 crisis. FINRA Rule 4370, entitled "Business Continuity Plans and Emergency Contact Information," requires member firms to "create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption." These BCPs must be "reasonably designed to enable the member to meet its existing obligations to customers" and must be made available promptly upon request to FINRA staff. With shelter-at-home orders in place in most states and most advisors working remotely, firms are being forced to re-think the ways they conduct business – and now is the time for firms to revise existing BCPs as new policies and procedures are being implemented. For example, firms need to document the steps they are taking to make sure they are adequately staffed with sufficient personnel to process securities orders.

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