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## **CLIENT ADVISORY: DEALING WITH DISGRUNTLED INVESTORS**

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Many money managers are confronted by an unhappy investor at some point – usually after a downturn in performance. Investor claims could have a big impact on your bottom line and your peace of mind, but an attorney experienced with investor claims can help you avoid or, if necessary, defeat such claims.

Our firm consults with hundreds of investment advisers about many aspects of their business, and we have handled a wide variety of investor claims and disputes over the years. We are particularly proud of recently winning an arbitration proceeding that involved a claim for \$50 million. Based on our experience, here are a few practical suggestions on how to protect yourself from a disgruntled investor.

### BE PREPARED

Don't be surprised to find that, if you lose money, one or more of your investors will claim to be "shocked" by the losses and insist that they were promised that there was no such risk. Your best defense against such "fraud" claims will be your marketing materials and client agreements. Make sure that these documents are up to date and that all material risks are explained and accepted. Also, make sure that you follow any limitations or other descriptions of your investment strategy that are in the materials you give to investors.

Unhappy investors also sometimes complain about "mismanagement." To defend against such claims, it will be important to show that your interests were aligned with your investors. One of the best ways is to "eat your own cooking" by investing your own money along with your investors (whether in a hedge fund or a separate account). Clients are usually reassured if they learn that you lost money too, and, even if they aren't, your losses will be undeniable evidence of your good faith belief in your investment strategy.

### BE COOPERATIVE

The first instinct of many money managers, when confronted by an angry investor, is to want to hit back. That is certainly understandable, but it usually is better to try to be constructive. Most claims begin with an inquiry or request, and many potential claims can be defused by a cooperative answer. Conversely, an investor who feels "stonewalled" will be much more likely to file a claim. That doesn't mean that you have to give in to every request, but you should do your best to show your investors that you are not trying to hide anything.

Cooperation is important, because you can suffer serious (and sometimes irreversible) consequences from the mere filing of a claim in court or arbitration. Any such claim may need to be disclosed to existing and potential clients, auditors and insurers (and in some cases, regulatory authorities). Simply having a claim outstanding – no matter how unjustified – will make it much harder to solicit and keep other investors. So it is important to try to resolve any problem before a claim is filed.

### BE PATIENT

Our clients deal with millions of dollars of investment risk, but it is easy to be disoriented by the risks of litigation. One common pitfall is to be too anxious to resolve any dispute as quickly as possible. Too much urgency can be counter-productive.

Don't rush. The wheels of justice usually grind slowly, but that may be a good thing if you are faced with an unhappy investor. The conventional wisdom among lawyers is that time tends to favor the defendant. After all, it is the plaintiff who wants to change the status quo – usually by getting the defendant to write a check. And plaintiffs tend to get more reasonable about settling a case when they realize that they will have to spend time and money if they pursue it.

### FIGHT IF NECESSARY

The sad truth is that, if you are sued, you can't really win. Even if you ultimately prevail, it will be very costly in attorneys' fees, your lost time, and sleepless nights. But losing is much worse. An adverse arbitration award or court judgment, especially one that includes findings of fraud or mismanagement, can be disastrous for a money manager. At the very least, it is something that you will have to explain for the rest of your career in the securities business.

Another sad truth is that being right doesn't always guarantee that you will win your case. Unfortunately, even meritless claims sometimes prevail. Litigation always has a measure of irreducible and unquantifiable risk – like the risk of infection in surgery. It can be hard for arbitrators, judges or juries to understand why a securities professional lost money and even harder to resist the temptation to give something to a claimant who is personally appealing or sympathetic.

If you are sued, be prepared to fight for your professional life. You and your lawyer will need to educate the arbitrator (or judge or jury) about the investment world. You must explain that you disclosed the risks, that the claimant understood and accepted these risks, and that you did the best job that you could for your investors.

You don't want the case to become a matter of "he said – she said." Showing that the materials given to investors disclosed the risks should help tip the balance in your favor. Depending on the stakes, it may also be worthwhile for your lawyer to bring in expert witnesses, other investors or business associates to testify in order to corroborate your testimony and give context for any disputed issues.

CONCLUSION

A claim by a disgruntled investor can have serious consequences, but you can head off most claims by being prepared and reasonably cooperative. Be prepared to fight if necessary, however, and make sure that you have experienced legal assistance.