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32

DEFAMATION AND FORM U-5

Bruce S. Schaeffer

The valuable assistance of Samantha Rabin of the Securities Arbitration Commentator, Lewis S. Fischbein, Esq. of Coblence & Warner and Ethan A. Brecher, Esq. of Liddle & Robinson, L.L.P. and particularly John Maltbie, Esq. in the research and preparation of this article is greatly appreciated and acknowledged.

TABLE OF CONTENTS

I. Introduction

This is an issue that can cut two ways.

Picture this: Ronnie Goodbroker is a registered representative with the firm of "Weget Revenge". Goodbroker was a registered rep for almost 10 years, with a book of hundreds of clients with millions of dollars invested at the Revenge firm.

Goodbroker got a better offer from another firm, took his clients and moved. The Revenge firm filed a Form U-5, required when a registered representative terminates his employment with a brokerage firm, and on it they stated that the reasons for the termination were embezzlement, fraud and a host of other securities laws violations. The Revenge firm knows there is no foundation for these allegations.

How would you feel if you represented Ronnie Goodbroker and you were told by a court in the State of New York that you had no remedy for this. That would be the result under Herzfeld and Stern, Inc. v. Beck 572 NYS2d 683 (App. Div. First Dept. 1991) and Culver v. Merrill Lynch and Co.. Fed. Sec. L. Rep. (CCH) Para. 98,811 (S.D.N.Y. July 17, 1995). The essence of these two decisions is that an absolute privilege must be granted to a firm filing a Form U-5 and that, therefore, no action for defamation will lie.

On the other hand, picture this: Reputable Brokers has a registered representative who's been nothing but trouble. The firm allows him to resign and makes no mention of his various perfidies on his U-5 for fear of being sued for defamation. The broker, Johnny Rogue promptly gets another job with Other Reputable Brokers and fleeces many of their customers. In what are now referred to as "dumpback" cases Other Reputable Brokers brings an industry arbitration against Reputable for failing to disclose Rogue's behavior on his U-5.

The securities industry loves arbitration to resolve disputes. That is why most firms require customers to sign arbitration agreements in their opening account forms and Form U-4 requires industry people to agree to arbitrate complaints. Accordingly, the issue of defamation on U-5's arises primarily (though not exclusively) in the securities arbitration context rather than in court. However, because arbitration decisions are rarely detailed and practically never provide the arbitrator's reasoning, it is difficult to determine the "law" in this area.

In an excellent article, Anne Wright, Assistant General Counsel to the NASD, reviewed the awards issued by self-regulatory organizations in such cases from 1989 through 1995 and found only 55 litigated cases that involved claims of defamation on Form U-5. She further refined the universe by stating "only seven of the 55 cases can be characterized as 'pure' defamation claims" and asserted that these cases represent a very

small fraction of the awards issued in industry disputes. See Wright, Anne H. Annual Review of Securities and Commodities Law 52 Washington and Lee Law Review 1299 (1995). However, it should be noted that many of these types of disputes are settled before an arbitration is filed and many more before an award is issued. This issue is not that rare and is becoming far more prevalent.

This article will review defamation in the securities industry and particularly on Form U-5 with its attendant disclosure reporting page. First there is a brief discussion of Forms U-4, U-5 and the Disclosure Reporting Page and a review of the persons possibly defamed by libel or slander in these forms. Next, is a discussion of defamation, and absolute and qualified privileges and the malice/recklessness necessary to overcome the qualified privilege. This is followed by a review of the notorious case of Joseph Jett, some examples of how to lose in arbitration and a review of the judicial decisions in the area.

II. Persons Possibly Defamed

Anyone who files a Form U-4 Uniform Securities Industry Registration can be defamed on a Disclosure Reporting Page or Form U-5. Accordingly the universe of those possibly defamed is not limited to just stock brokers. Those potentially harmed include all those brokerage house personnel who are registered.

Additionally in today's environment of banks and insurance companies smashing into the area of financial services, most if not all of their sales personnel are becoming security licensed. Therefore,Forms U-4 and Forms U-5 are proliferating with respect to personnel in banking and insurance and to many who are denominated financial planners and investment advisors as well.

The American Council of Life Insurance has 557 member life insurance companies which employ hundreds of thousands of insurance and securities representatives. The majority of those representatives are registered with the National Association of Securities Dealers to sell securities as part of their insurance practice. Roughly half of all registered representatives licensed by the NASD are associated with broker-dealers affiliated with life insurance companies. These insurance affiliated registered representatives total approximately 250,000 individuals. See Amicus Brief of American Council of Life Insuance in Dawson v. New York Life on appeal to the United States Court of Appeals for the Seventh Circuit. Testimony at the Dawson trial indicated that New York Life Securities, Inc., alone, the broker-dealer affiliated with New York Life Insurance Company, processes as many as 4,000 Forms U-4 and U-5 each year.

III. The Forms: U-4, U-5 and the D.R.P.

As part of its statutory mandate, the NASD (1) is required to maintain records of its member securites firms and their registered representatives, for at least five years, and (2)

has established standards for the uniform licensing and registration of securities professionals and, in so doing utilizes two forms. Form U-4 when they become associated with a member firm and U-5 when they leave.

The information reported on these forms is entered into the "Central Registration Depository" ("CRD"). CRD is a computer database developed by the NASD and the securities commissions of the 50 states, containing registration information, including customer complaints, as well as regulatory and enforcement actions taken against securities industry personnel. CRD is operated by NASD through a subsidiary, NASD Regulation, Inc. CRD expedites registration in all 50 states through a centralized filing facility. The data entered into CRD is accessible by federal and state regulatory authorities, other self-regulatory organizations and potential employers of a securities professional. Section 15A(I) of the Exchange Act also requires the NASD to make certain information on CRD available for public disclosure, and immunizes the NASD from liability to any person resulting from such disclosure. See Amicus Brief of National Association of Securities Dealers in Dawson v. New York Life on appeal to the United States Court of Appeals for the Seventh Circuit.

A. Form U-4

Whenever a financial professional starts to work in the securities industry, or starts a new job in the securities industry, the financial, professional and his/her employer must fill out a Form U-4 "Uniform Application for Securities Industry Registration or Transfer". This form provides the applicant's name and CRD and social security numbers as well as the name and address of the employer and the employment date. It goes on to provide information about the jurisdictions in which the applicant is to be registered as well as the types of examinations or registrations requested. Of course, there are different examinations and registration requirements for registered option principal, securities trader, branch office manager, supervisory analyst, general securities principal and introducing broker/dealer among others.

The form goes on to provide personal data, residential history and employment and personal history followed by a question as to whether the applicant is currently engaged in any other business either as a proprietor, partner, officer, director, trustee, employee, agent or otherwise. The form then requires the applicant to swear or affirm that the answers and information given are true and certain other representations. After the applicant's signature is a portion which must be completed by the firm. The last sentence of this portion of the form reads "this firm has communicated with all of the applicant's previous employers from the past three years." And then there is space provided to list the employer, the name of the person contacted, the position of the person contacted and the dates during which the applicant was employed as well as a box for describing how the contact was made.

The applicant is also required to answer more than thirty questions focusing on investment related complaints whether initiated by the SEC, a foreign government or other self-regulatory organizations, as well as other questions about customer complaints alleging compensatory damages of $10,000 or more. This information is fed into the CRD system and thereby becomes, in large part, publicly available.

B. Form U-5

Whenever an individual for whom a U-4 has been filed terminates his/her employment, a Form U-5 "Uniform Termination Notice for Securities Industry Registration" must be filed. The form must be filed within thirty days of the individual's termination according to the NASD rules and the firm is further required to update the form within thirty days of learning anything that makes the original filing inaccurate. The form was developed within the securities industry by the various exchanges, the North American Securities Administrators Association, the NASD and the SEC. The NASD rules also require that terminated individuals be given a copy of their Form U-5 and any amendments.

The form is straight forward with sixteen numbered questions. Basically, the problems come up with respect to questions 13, 14 and 15 which read as follows:

(13) WHILE EMPLOYED BY OR ASSOCIATED WITH YOUR FIRM, WAS THE INDIVIDUAL:
A. involved in any disciplinary action by a domestic or foreign governmental body or self-regulatory organization with jurisdiction over investment-related business?
B. the subject of an investment-related, consumer-initiated complaint that:
(1) alleged compensatory damages of $10,000 or more, fraud, or the wrongful taking of property?
(2) was settled or decided against the individual for $5,000 or more, or found fraud, or the wrongful taking of property?
C. convicted of, or plead guilty or nolo contendere ("no contest") in a domestic or foreign court to:
(1) a felony or misdemeanor involving: investments or an investment-related business, fraud, false statements or omissions, wrongful taking of property, or bribery, forgery, counterfeiting, or extortion, or gambling?
(2) any other felony?

(14) Currently is, or at termination was, the individual involved in an investigation or proceeding by a domestic or foreign governmental body or self-regulatory organization with jurisdiction over investment-related businesses?

(15) Currently is, or at termination was, the individual under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct?

The directions atop these questions state that if the answer to any of them is "yes" the firm filing the form should attach "complete details of all events or proceedings on DRP's". The DRP or Disclosure Reporting Page is set up as a vehicle to describe whatever event or litigation required the "yes" answer.

The NASD routinely initiates an investigation whenever a Form U-5 reports that an individual was terminated for cause or contains an affirmative response to questions 13 thru 15. The Form U-5 is often the first indication that the NASD receives regarding possible misconduct by members of the securities industry, and investigations of misconduct reported on the Form U-5 frequently lead to the initiation of disciplinary action by the NASD. Also, every person whose U-5 reason for termination is disclosed as "discharged" in response to Question 12 is investigated.

C. The DRP

The Disclosure Reporting Page ("DRP") contains specific questions about customer complaints and the directions advise the members that it is very important that clear and concise information be provided for each item on the form. A copy of the Form U-5 and the DRP must be provided to each terminated individual. It should also be noted that affirmative answers on a Form U-5 and DRP trigger reporting obligations with respect to that individual on the Form U-4 submitted by a subsequent employer.

A secondary purpose of the Form U-5 and the DRP is to inform potential employers of some event regarding the individual that may raise a regulatory issue. NASD Notice to Members 89-57 notes the NASD's belief that the circumstances of a termination may be relevant to a hiring decision and should be readily available to an NASD member firm for that purpose. The potential employer is thus allowed to compare the information to any statements made by the potential employee about the termination. Under NASD rules each firm is required to investigate the background of its potential registered personnel.

IV. Choice of Law

It must be understood that defamation is a state law claim. Therefore, the first question is which state's law should prevail.

In the very recent case of Glennon v. Dean Witter Reynolds Inc. 83 F 3d 132 (6th Cir 1996) the Court held that in federal question cases a district court entertaining pendent state claims such as defamation should follow the choice of law rules of the forum state.

The forum state will have its own conflicts of laws rules. Most states choice of law rules consider the factors listed in the Restatement (Second) of Conflict of Laws §145. These factors are (a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicile, residence, nationality, place of incorporation

and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered.

This underlying deference to state defamation law was described by the Seventh Circuit as follows:

> "Defamation is an area of state law, and the various defamation privileges are an integral part of defamation. It would be surprising if, in authorizing the arbitration of their disputes, the parties had intended the arbitrators to make up a law of defamation to apply to those disputes. More likely they were expected to apply the defamation law of some state, and Illinois is as plausible a candidate as any, since (the broker) worked in (the firm's) Chicago office. So let us apply the Illinois law of privilege." Baravati v. Josephthal, Lyon & Ross 28 F3d 704,706 (7th Cir 1994)

V. Introduction to Defamation Law

According to hornbook law, defamation is made up of the twin torts of libel and slander--one being, in general, written while the other, in general, is oral. It is said there is a great deal of the law of defamation which makes no sense and that it contains anomalies and absurdities for which no legal writer has ever had a kind word

The development of defamation law has been haphazard. Originally, common law courts did not have jurisdiction; cases involving defamatory utterances were left to the seigniorial courts. Then, in the sixteenth century there was a conflict over jurisdiction between the two sets of tribunals. Ultimately common law jurisdiction was established yielding an unexpected flood of actions. The common law judges were angered by the number of cases and "so proceeded to hedge the remedy about with rigid restrictions, some of which still survive." (see Prosser and Keeton on Torts, Fifth Edition § 111)

An in depth study of the law of defamation is beyond the scope of this article. However, a simplistic definition would be that defamation is a communication which tends to injure the reputation, or diminish the esteem, respect, goodwill or confidence in which the plaintiff is held, or to excite adverse, derogatory or unpleasant feelings or opinions against him or her. (Prosser and Keeton § 111) According to the Secondary Statement of Torts it is a communication that tends to so harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating or dealing with him.

Defamation is a civil action, personal to a living person and cannot be founded on the defamation of another. It has been found that a corporation or other business organization has prestige and standing in the business in which it is engaged and language which casts an aspersion upon its honesty, credit, efficiency or other business character is also actionable.

An action for defamation, is subject to many defenses. For one thing, as frequently stated, truth is a perfect defense. However, in most securities industry cases the real threshhold issue is the defense of absolute privilege versus qualified privilege. The law has carved out certain areas of absolute privilege. They are judicial proceedings, legislative proceedings, executive communications, consent of the plaintiff, husband and wife communications and political broadcasts.

In the context of this article, the claimed grounds for absolute privilege that come into play are generally the privilege for judicial proceedings--in many cases defendants have claimed absolute privilege with respect to filing U-4 or U-5 Forms claiming they are quasi-judicial in nature. Additionally, consent based on the signing of Form U-4's has been raised as an absolute privilege and has been regularly dismissed as any basis for claim of absolute privilege.

The law has also recognized a number of qualified privileges. These are the interest of the publisher; interest of others; common interest; and fair comment or fair reporting on matters of public concern (see Prosser and Keeton § 115). In Dawson v. New York Life (discussed at length on p. 27) a claim was made that publications were not defamation because they were simply fair reporting of judicial proceedings.

The cases involving defamation in the securities industry have all held there is some privilege: either absolute or qualified. However, the defense of qualified privilege can generally be overcome by a showing of malice or abuse of that privilege. It is in this area that all of the disputes relevant to this article are fought. The courts are frequently fuzzy on exactly which qualified privilege they find available and spend more of their discussion on what level of malice or abuse they recognize as necessary to overcome the qualified privilege.

One should not forget that truth is the perfect defense. To create liability for defamation there must be a publication that is both defamatory and false (see Prosser and Keeton § 116). The truth or falsity of the matter published is a question of fact specific to each case decided by the arbitration panel just as they would decide any other fact or question involved.

Absolute privilege is a perfect defense. However, a qualified privilege can be overcome by a showing of malice or abuse.

VI. Abuse of Privilege/Malice

If the forum determines that statements are protected by only a qualified privilege, then a claimant or plaintiff may still prevail by showing that the statements were published with malice. The requisite showing by a plaintiff to overcome a motion to dismiss is minimal. See Mihlovan v. Grozavu, 72 N.Y.2d 506, 534 N.Y.S.2d 656, 657-58 (1988)

("'given their most favorable intendment' . . . plaintiff's allegations that the statements were maliciously made, if proven, would overcome that [qualified privilege] defense"); Matherson v. Marchello, 100 A.D.2d 233, 473 N.Y.S.2d 998, 1003 (2d Dep't 1984) (Titone, J.) (defamation action; "there is no requirement that the plaintiff establish an evidentiary basis for the allegations of the complaint on a motion to dismiss made pursuant to CPLR 3211").

A. Common Law Or Constitutional Malice Can Overcome A Qualified Privilege

Either of two recognized types of malice may suffice to overcome a qualified privilege: (i) common law malice, which has a number of definitions – personal spite, ill will, or culpable recklessness or negligence – or (ii) constitutional malice: knowledge of falsity or reckless disregard for truth or falsity. Constitutional malice is shown where the defendant was highly aware of the probable falsity of the statements or the defendant entertained serious doubts as to their truth. See, e.g., Liberman v. Gelstein, supra, 590 N.Y.S.2d at 862-63 (either constitutional malice or common law malice sufficient to defeat common interest privilege; summary judgment decision involving communications between members of board of governors of tenants' association); Shapiro v. Health Ins. Plan of Greater N.Y., supra, 194 N.Y.S.2d at 513 (common interest privilege defeated by actual [i.e., common law] malice, which means personal spite, ill will, or culpable recklessness or negligence).

"In this context, however, spite or ill will refers not to defendant's possible feelings about plaintiff, but to the speaker's motivation for making the defamatory statements." Liberman, supra, 590 N.Y.S.2d at 863.

Also, common law malice "may be inferred from a defendant's use of expressions beyond those necessary for the purpose of the privileged communication or from a statement that is `so extravagant in its denunciations or so vituperative in its character' as to warrant an inference of malice." Herlihy v. Metropolitan Museum of Art, 214 A.D.2d 250, 633 N.Y.S.2d 106, 112 (1st Dep't 1995); accord, Bardey v. Brooke-Hitching, 191 A.D.2d 243, 595 N.Y.S.2d 4, 5 (1st Dep't 1993) (statements posed jury question); Vacca v. General Electric Credit Corp., 88 A.D.2d 740, 451 N.Y.S.2d 869, 871 (3d Dep't 1982) (calling owners of business "crooks and hijackers" went far beyond what was necessary); Mercedes-Benz of North America v. Finberg, 58 A.D.2d 808, 396 N.Y.S. 2d 260, 262 (2d Dep't 1977) (defendant's remark to a prospective employer that plaintiff had padded bills while in defendant's employ, if false, would raise an inference of malice).

Presenting "slanted documents" (such as an amended U-5) evinces malice as well. Brown v. Albany Citizens Counsel on Alcoholism, 199 A.D.2d 904, 605 N.Y.S.2d 577, 579 (3d Dep't 1993) (charges of fraudulent conduct).

VII. Defamation in the Securities Industry--the Notorious Case of Joseph Jett

The story of Joseph Jett was front page news in 1994 and 1995 and is again in 1997. It involves many elements of defamation in the securities industry, so many that defamation on the Form U-5 is a minuscule element in the case.

Procedurally, Jett involves an industry arbitration as well as an action in New York Supreme Court. According to the plaintiff Jett, "Legally the action is about defamation. Factually the action is about a Wall Street persecution, perpetrated and participated in by all of the defendants through a campaign at many levels, designed to destroy plaintiff Joseph Jett's reputation." (see Jett Amended Complaint New York State Supreme Court Action IAS Part 36 Index #110582/95)

The Jett case involves defamation in a far broader context than defamatory statements made on a U-5; however, it is instructive for an understanding, in general, of the key issues in this area.

Joseph Jett was the former head of Kidder Peabody's Government Securities Trading desk, and one of the few African Americans to obtain to such a high level of responsibility on Wall Street. The defendants originally named included Kidder Peabody, a large and privately held Wall Street investment firm, General Electric, a public company and Kidder's corporate parent, present and former senior executives of both companies and the outside lawyers for Kidder and GE. (See Jett Amended Complaint, paragraph 2)

In 1993 Jett had received Kidder's Man of the Year award and been given a multi-million dollar bonus. Then, according to Jett's attorneys, they turned on him. In 1994, Kidder and its parent, GE, repeatedly made statements to the press that Jett had generated "phantom" profits on "phantom" trades. This sort of narrowing the scope of blame to one individual, a former Man of the Year, is strangely similar to the Dawson case discussed below.

The defendants in Jett hired Gary Lynch, former head of the SEC Division of Enforcement, to study the situation. Three days after Jett's termination, Kidder filed an NYSE arbitration claim against him for fraud and breach of duty as an employee based upon the alleged "scam" for which they fired him.

The report commissioned by Kidder which came to be known as the Lynch report, came up with the very same conclusions that Kidder and GE alleged, although it was supposed to be an independent objective, thorough and comprehensive investigation into what went wrong. (See Jett Amended Complaint, paragraph 5)

Jett's lawsuit contended that all of these allegations and findings are lies and that they are merely seeking to make him a scapegoat. (See discussion of scapegoat cases below) Jett's Amended Complaint alleged that the defendants, in an effort to hide millions

of dollars of corporate losses, shifted the blame for the losses on Jett by a malicious and false campaign that charged him with engaging in phantom trading.

It is interesting to note that none of Jett's superiors, who had direct responsibility over him, were castigated or accused of running scams in a manner similar to Jett. This has the appearance of scapegoating in the face of Jett's allegations that his superiors knew everything he was doing.

A fact that should be noted with caution: Jett left all of his earnings--over $5 million--on deposit in a Kidder account, which was frozen by Kidder when they fired him and made the allegations against him. This corpus is the subject of the long and drawn out arbitration of the matter going on before the New York Stock Exchange.

The interim results (as of 12/19/96) of the NASD arbitration, chaired by the eminent and highly respected Professor Constantine Katsoris of Fordham Law School, are interesting: by a two to one decision, the arbitrators have held that Kidder must turn over $1 million to Jett. The panel reserved decision with respect to certain other monies and the obligation to pay millions of dollars of Jett's legal fees. Jett lost his claim for deferred compensation.

It was a two to one decision. The dissenter voted for an award of $60 million in favor of Kidder Peabody. Now that's a difference of opinion.

VIII. The Jett Court Case--A Partial Primer in Defamation Law

The Jett case, more than most industry disputes between brokers and firms, exhibits many defamation issues. Unlike most U-5 cases, there is no threshold question with respect to absolute privilege or qualified privilege. At issue in the Jett case is whether or not certain qualified privileges exist and whether or not statements were made with the malice necessary to defeat those privileges.

On March 18, 1997, roughly two years after Jett filed his action in New York State Supreme Court, the court confirmed that Mr. Jett's complaint states a cause of action. The Court came to this conclusion in a ruling on a motion to dismiss.

Defendants, in their motion to dismiss for failure to state a cause of action, argued that any statements they made (to almost every press outlet in the world, PR Newsline, Bloomberg Business News, the Wall Street Journal, the New York Times, Business Week and New York Magazine, among others) is subject to a qualified privilege--the common interest privilege.

Jett argued that no common interest privilege existed because the defendants made public statements. The plaintiff further argued that recent case law refuses to extend the common interest privilege to statements made to the press. Finally, as in most scapegoat

cases, the plaintiff argued that the defendants' bad faith and improper purpose independently defeated the existence of the common interest privilege.

Jett went on to argue that defendants' defamatory statements were made with malice, which would defeat a common interest privilege otherwise in existence. Jett's argument was that either common law malice or constitutional malice suffices to overcome the common interest privilege.

Defendants argued that their defamatory statements were subject to a "gross irresponsibility" standard under New York law while Jett argued that the "gross irresponsibility" test was fashioned for, and has been applied to, only media defendants rather than non-media defendants.

Finally, defendants made an argument on statute of limitations grounds that statements made more than one year before the filing could not be part of the action. Under the standard of review appropriate for a motion to dismiss the complaint for failure to state a cause of action the plaintiff's claims were sustained in all matters except with respect to the statute of limitations. This should be a caution to all practitioners to note the very short statute of limitations that normally attaches under state law to a defamation action. In New York it's one year.

The court held:

"...Contrary to plaintiff's contention, there is no New York law that allows tolling of the statute of limitations because of an alleged campaign of defamation (see CPLR 201). Libel law is clear that the one-year statute runs from the date of publication (Meyer v. Shearson Lehman Bros., Inc., 211 AD2d 541, 543; Stafford v. Bickford, 159 AD2d 456, 457)."

Additionally, as noted above, Jett named several individuals as defendants. Although these people were not alleged to have "said" anything defamatory about Jett, it was the plaintiff's allegation that these defendants were liable as part of a conspiracy.

As to these "non-uttering" defendants, the court held that "there is no such tort as conspiracy to libel". Therefore, because New York Law requires that in "an action for libel or slander, the particular words complained of shall be set forth in the complaint" (CPLR 3016(a)), and because no words were spoken by these defendants, the complaint as to them was dismissed.

However, it must be emphasized that at the time of this writing (April 1997), practically all of Mr. Jett's causes of action for defamation survived defendants' motion to dismiss.

IX. Selected Arbitration Decisions

Securities arbitration cases focusing on claims for defamation are growing. A review of certain selected decisions graciously provided by Samantha Rabin of Securities Arbitration Commentator gives the practitioner a feel for the "law" in arbitrations. For further information on these and other arbitration decisions the reader should contact the Securities Arbitration Commentator (201) 761-5800.

It must be noted that the explanations below of NYSE awards are very brief because less than 1" of space is provided for the arbitrators to describe their decision. NASD awards, in contrast, decisions provide a far better understanding of the claims and defenses.

A. Benzer v. Shearson Leman Brothers

In this New York Stock Exchange arbitration, claimant, a registered representative and former employee, alleged that Shearson willfully made false statements on his U-5 to his detriment resulting in lost wages, lost future earnings and lost benefits and bonuses. Claimant also sought to have the U-5 amended. The very brief decision of the arbitrators is interesting because they found Shearson was grossly negligent in its failure to verify the accuracy of the information contained in the U-5 Form and attachments. They awarded claimant $65,000 in compensatory damages and $65,000 in punitive damages. However, the arbitrators specifically noted, "There is no finding of defamation."

B. Polk v. Merrill Lynch

In this NASD arbitration, claimant alleged that Merrill Lynch filed a false and defamatory amended U-5. Polk alleged the amended Form U-5 was filed to coerce him to pay $2,400 to Merrill Lynch which they alleged Polk owed to them as reimbursement for their paying one of Polk's customers for her losses. Polk contended that the filing of the false and defamatory amended U-5 damaged his good character and business reputation and his career in the securities industry.

One of the affirmative defenses put forth by Merrill Lynch was that the claimant had released the respondents from any and all liability in connection with the amended Form U-5 based upon his execution of a Form U-4 during his employment. This defense of "consent" to being defamed was ignored by the arbitrators.

From the brokerage firm's point of view, the Polk case is an example of how to do it wrong. The matter at issue was $2,447.24. Merrill Lynch was ordered to pay the claimant damages in the amount of $200,000. Additionally, Merrill was ordered to file an amended U-5 within 30 days, with specific information ordered by the panel.

C. Ulrich v. Eaton Vance

In this NASD arbitration, claimant alleged that he was defamed in connection with a filing of the Form U-5. Ulrich contended that the Form U-5 was falsified in an attempt to extort and persuade him to accept a severance package of relatively small value and that such false U-5 essentially "blackballed" him in the industry.

Respondents maintained that the statements they made on the U-5 were truthful in all respects and further contended that the statements were subject to an absolute and/or qualified privilege, were not made with malice or ill-will, and were not published in a manner necessary to support a claim for defamation. They further denied that they had interfered with the claimant's business relationships in any way.

The panel found the respondents liable to the claimant in the amount of $625,000. They also found the respondents liable for legal fees and awarded $1,250,000 in punitive damages. The arbitrators found, "Punitive damages are appropriate based on the arbitrary enforcement of company policy toward employees which evidenced a blatant disregard of equal treatment in dealing with the claimant. The panel also believes that the U-5 was improperly used in the termination negotiations in order to manipulate a settlement with claimant." This selective aspect is discussed below in the scapegoat cases.

D. Promissory Note Cases

As securities arbitration practitioners are well aware, big producers are often induced to move to a new firm by the payment of advance compensation usually in the form of an interest free loan secured by a promissory note which is forgiven over time. They are called "transitional compensation" or "signing bonuses".

Frequently when these situations fall apart, the brokerage firm decides that the promissory note should not be forgiven and seeks to have such signing bonuses repaid. As noted above in the Jett case, in order to secure their claim (through self help,) the firms frequently seize the assets of the brokers which are in the accounts at the firm, and allege they are entitled to those assets as an offset for the promissory note.

Something which also seems to happen with some frequency is that when the dispute is not resolved amicably, brokerage firms file amended Form U-5's which are less than flattering.

1. Merrill Lynch v. Maize and Steers

In this NASD arbitration, Merrill alleged that Maize and Steers breached the terms of the promissory notes they signed with Merrill Lynch. Maize counterclaimed, alleging breach of contract, fraudulent misconduct and defamation which resulted in her reputation being ruined and prevented her from pursuing her career as a commodities broker. Steers

also counterclaimed, alleging that Merrill committed breach of contract, fraud, misrepresentation, negligent interference with prospective economic advantage, breach of the covenant of good faith and fair dealing and constructive discharge.

Merrill was seeking compensatory damages in the amount of $510,000 to repay the promissory notes. In his counterclaim, Maize requested dismissal of Merrill's claim on the promissory note and compensatory damages of $5 million. Steers requested dismissal of the promissory note claim and sought compensatory damages of $1 million. Merrill won its claims, but so did Maize and Steer. The panel ordered Maize to repay Merrill $510,000 in principal plus $56,333 in interest and $50,000 in attorney's fees as provided in the terms of the promissory note. However, the panel also ordered Merrill Lynch to pay to Maize damages in the amount of $2,125,000.

With respect to Steers' case, the panel ordered that he repay Merrill $15,000 in damages, $1,625 in interest and $5,000 in attorney's fees as provided in the promissory note. However, they ordered Merrill Lynch to pay Steers' damages in the amount of $275,000.

At least Merrill got paid its promissory note. In the two arbitrations discussed below, the promissory notes were forgiven and the allegedly defamed brokers were awarded damages as well.

2. Berkeley v. Paine Webber

In this NASD arbitration, the claimant was given advanced compensation of $775,000 in the form of a promissory note. Additionally, there were other forms of contingent compensation at issue.

Claimant requested damages of $3 million as compensation for a bonus he alleged he was entitled to, plus a 25% contingent form of compensation and $10 million in damages arising from defamation. He also sought $12,014,228 in damages arising from interference with prospective advantage and injurious falsehood. Finally, claimant sought a decision that he was not liable under the promissory note for the $775,000. Paine Webber sought to have his claim denied and be repaid the $775,000.

The panel held the claimant was entitled to damages for defamation, interference with prospective advantage and injurious falsehood in the amount of $1 million. This award was described by the panel as solely compensatory and specifically contained no punitive elements. Furthermore, the panel found the claimant was not liable for the $775,000 promissory note. Finally, the panel requested, on its own motion, that PaineWebber amend claimant's Form U-5 in accordance with their specific directions.

3. Agron v. Paine Webber

This NASD arbitration also involved the fact pattern of a promissory note sought to be repaid by the freezing of the broker's account with the firm.

In this case, the broker alleged that a customer account form needed a particular customer's signature and that with the customer's specific direction to him, the broker signed the customer's name. Thereafter, the firm discharged Mr. Agron, alleging he had engaged in forgery.

The claimant requested $250,00 in damages; that the panel order PaineWebber to disgorge and pay over to claimant all of the amounts to which it had been, and could reasonably expected in the future to be, unjustly enriched as a result of its wrongful termination and breach of contract; that the panel order the respondent to pay not less than $250,000 as an award of punitive damages; that the panel declare that the note payable was void and unenforceable; and, that the panel order that the firm unfreeze claimant's personal accounts.

The panel voided the note and awarded Agron $50,000 as actual damages for freezing his account and $240,000 as satisfaction of his remaining claims. There was no award of punitive damages.

X. Judicial Decisions

Even though the securities industry generally requires industry disputes be resolved by arbitration, they sometimes end up in court. They can get to court on a motion to affirm or vacate the arbitration award and the court's decision in such instances can sometimes be appealed, yielding a higher court's review. Also, in some circumstances, the issue is originally brought in court.

A. Absolute Privilege

There are only two cases that have decided that Form U-5 filings are entitled to absolute privilege. Both cases purported to apply New York law in holding that Form U-5's are in the nature of statements made in connection with judicial or quasi-judicial proceedings. The first one - Herzfeld and Stern, Inc. v. Beck 572 NYS2d 683 (App. Div. First Dept. 1991) - was decided August 1, 1991.

The facts and holding of the case are described in the Court's memorandum decision as follows:

> Until March 30, 1984, plaintiff Warren Beck was employed by defendant Herzfeld & Stern, a registered securities broker and dealer, as a research analyst and securities representative. Following his dismissal from the company, defendant,

in compliance with regulatory requirements, filed a Uniform Termination Notice for Securities Industry registration (U-5 notice), dated April 26, 1984, which advised, among others, the Securities and Exchange Commission and the New York Stock Exchange (NYSE) that plaintiff was no longer associated with Herzfeld & Stern. The reasons stated for Beck's termination included that he had (1) failed to obtain proper permission before entering orders to purchase securities for a customer who was a control person of the company whose securities were being acquired; (2) purchased without first seeking permission those securities through a margin account, thus exposing the firm's capital to undue risk; and (3) failed to know his customer. This U-5 notice superseded a prior one that did not contain the foregoing charges because, defendant claims, the facts were not fully known at the time.

Upon receipt of the second U-5 notice, the NYSE instituted an investigation into Beck's conduct. Accordingly, Charles A. Wills, Senior Enforcement Investigator of its Department of Enforcement, requested information from Herzfeld & Stern relating to the accusations against plaintiff. In response, defendant wrote two letters to Wills, dated June 3, 1984 and June 8, 1984. The complaint in the instant matter alleges four causes of action for libel and defamation, one each being founded upon the U-5 notice of April 26, 1984 and the defendant's two communications to Wills and a forth claim asserting prima facie tort. This appeal is from the denial by the Supreme Court of defendant's subsequent motion pursuant to CPLR 3212 for summary judgment dismissal. In that regard, there is merit to the contention by Herzfeld & Stern that since the writings in question were prepared in connection with a quasi-judicial proceeding, they are absolutely privileged.

The other case finding absolute privilege is Culver v. Merrill Lynch & Company , 1995 WL 422203, Fed. Sec. L. Rep. P 98,811 (S.D.N.Y. July 17, 1995), a decision of the United States District Court for the Southern District of New York. In this case, the District Court held that statements made on Form U-5s are in the course of a quasi-judicial proceeding and are therefore entitled to a quasi-judicial absolute privilege.

Mr. Culver had worked for Merrill Lynch as Vice President of its Commodity Trading and Finance Group. He claimed to have been fired for being a whistle blower with respect to improper forward trading allegedly done by members of Merrill's London Metal Exchange Trading Desk. Culver asserted that Merrill was scheming to cheat a trading client out of $15,000,000. After Culver was fired, Merrill filed a Form U-5 stating, "Mr. Culver was terminated after Firm management learned he took no corrective action upon becoming aware that a transaction had been entered by a subordinate which was violative of Firm policy and was not forthcoming when initially questioned about the transaction".

Ruling in favor of Merrill, the District Court relied on Herzfeld & Stern and held, "[w]e similarly find that the written statement filed by Merrill Lynch pursuant to its Form U-5 (Uniform Termination Notice) requirement was made in the course of a quasi-judicial proceeding, and was material and pertinent to the reasons for Culver's termination.

Therefore, and notwithstanding any malice by Merrill Lynch, this statement was absolutely privileged, and we dismiss Culver's first defamation claim." No other courts have taken this approach.

B. Qualified Privilege

Neither of the two absolute privilege cases noted above have been accorded much weight by other courts. Just sixty two days before the Herzfeld & Stern decision, the well-respected Second Circuit Court of Appeals found that a qualified, not absolute privilege attached to the filing of Form U-5's. In Fahnestock & Co. v. Waltman, 935 F2d 512 (2d Cir. 1991), the court held that New York Law applied and that the defamation law of New York allowed only a qualified privilege. The Second Circuit thereby confirmed an arbitration Award which also had held that the brokerage firm was protected only by a qualified privilege in filing an amended U-5. The court said that considering the evidence of the firm's "flagrantly spiteful conduct demonstrating its intent simply to injure the employee's reputation", the arbitrators were proper in declining to extend the doctrine of absolute immunity to statements made to a quasi-official body.

In Kurschus v. Paine Webber 1996 WL 389303 (S.D.N.Y.), the United States District Court for the Southern District of New York found that the privilege which attaches to a Form U-5 is only a qualified privilege and made no mention whatsoever of either the Herzfeld & Stern or the Culver decisions.

No courts other than the two cases cited above have extended an absolute privilege to statements made on Form U-5 filings. Other courts have agreed that the NASD performs quasi-judicial functions by investigating, adjudicating, and sanctioning rules violations, and while an absolute privilege should be afforded to those self-regulatory activities, those courts have held that U-5 filings were preliminary to these functions and should be afforded only a qualified privilege. For example, the Seventh Circuit Court of Appeals held:

> But the submission of a U-5 form and its transmission (upon request) to members of the NASD are not stages in the association's quasi-judicial regulatory process. . . . This information service is remote from a judicial proceeding; and while a U-5 can trigger an investigation or even serve as evidence in a disciplinary proceeding against a member or broker, any item of information could do that. . .But it is only the absolute privilege that is at issue in this case. All conceded that, just as in the case of an employer's character reference, the firm has a qualified privilege to defame the employee on the U-5, a privilege forfeited (under Illinois law) only if the firm knows or is reckless in failing to discover that it is defaming him falsely.

Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 708 (7th Cir. 1994). The court went on to hold:

> To insulate [NASD] members from liability for the contents of their U-5s would be tantamount to allowing a member of the NASD to blackball a former employee from employment throughout the large sector of the industry that the membership of the association constitutes.

The Sixth Circuit, in Glennon v. Dean Witter Reynolds, Inc., 83 F.3d 132, 137 (6th Cir. 1996), found:

> Although the Form U-5 can trigger an investigation of a member or broker and may be used as evidence in a disciplinary proceeding, it is not part of a judicial proceeding. Because the Form U-5 is merely a preliminary or investigatory formality, not part of the NASD's quasi-judicial regulatory process, we conclude that under Tennessee law the statements contained therein are not entitled to an absolute privilege.

The Glennon court gave its reasoning as to the danger inherent in providing unfettered license to statements made in U-5 filings:

> To hold the doctrine of [absolute] privilege applicable to investigatory situations . . . especially [those] so very preliminary in nature . . . would be to give license to those with ill will and malice toward others to harass them unmercifully simply by addressing their vituperative comments to law enforcement or other governmental investigatory authorities.

Id. at 137 (internal quotations and citations omitted).

Other courts have also refused to apply the absolute privilege to statements made on a broker's U-5. In Prudential Securities, Inc. v. Dalton, 929 F.Supp. 1411, 1418 (N.D. Okla. 1996), the District Court found only a qualified privilege, concluding that "Baravati is the better view and also conforms to Oklahoma law" (citation omitted). Similarly, in Fahnestock, the Second Circuit simply stated that "Fahnestock's arguments [for absolute privilege] are without merit."

1. Fahnestock & Co., Inc. v. Waltman

In Fahnestock & Co., Inc. v. Waltman 935 F2d 512 (2d Cir 1991), the firm argued that the filing of a Form U-5 was absolutely privileged and, therefore, could not serve as a basis for an award for defamation. The arbitrators found that it could serve as a valid claim and as the basis for an arbitration. The Second Circuit agreed. The Second Circuit's decision was two-fold: First, such a defamation claim is actionable and second, it is also arbitrable. Once again the facts should be reviewed.

When Waltman, the employee, was originally terminated, Fahnestock filed a U-5 stating that the discharge was occasioned by "business consolidation". Waltman was not

an ordinary stockbroker. In fact he was hired to head Fahnestock's Retirement Trust Division and to manage and build Fahnestock's insurance products business. He acted as an insurance sub-licensee for Fahnestock and established a general agency in Pennsylvania for the purpose of marketing insurance and annuities for Fahnestock. Waltman was discharged when Fahnestock closed down its Retirement Trust Division. Then, a review of the proceedings shows, Fahnestock exhibited a streak of reprehensible and vindictive meanness which argues overwhelmingly against granting U-5's absolute privilege to a brokerage firm.

As the court found:

> When Fahnestock later was unable to locate some insurance files that it believed were maintained by Waltman, it contacted Waltman and requested that he return the files. Waltman refused to return the files, claiming that they belonged to his general insurance agency. Waltman explained that he would turn over the files only if Fahnestock obtained a release and indemnification from each registered agent named in the files.
>
> Instead of complying with Waltman's request, Fahnestock filed a Statement of Claim with the Director of Arbitration of the New York Stock Exchange ("NYSE"), requesting the following relief: return of the original files, damages and costs, and other expenses. Fahnestock then filed an amended Form U-5. On the amended form, Fahnestock changed its previous answer in response to the question about whether the employee was under "internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct, " from a "NO" to a "YES."
>
> Waltman filed an answer in the NYSE arbitration, denying the allegations that he wrongfully took Fahnestock's property. He also filed a counterclaim, in which he alleged that Fahnestock and three of its officers, the chairman of the board, the president, and the general counsel, defamed him by filing the amended Form U-5.
>
> During the course of eight hearings, the Arbitrators heard testimony concerning the chairman's threats to arrest Waltman for his failure to return the files, the chairman's instruction to refile the Form U-5 "in such a way as to indicate that [Waltman] had been fired for cause and noting that he had stolen property from Fahnestock," and the threats made to Waltman's current employer in an attempt to pressure Waltman into abandoning his defamation action. The Arbitrators awarded Waltman $56,000 in compensatory damages for wrongful discharge, $14,700 in legal fees, $100,000 for defamation and $100,000 in punitive damages. Liability was imposed on Fahnestock alone, and the claims against the individual officers were dismissed.

Additionally, the court found,

> At the arbitration hearings, the Arbitrators heard testimony that the chairman of Fahnestock gave instructions to refile the Form U-5 "in such a way as to indicate that [Waltman] had been fired for cause and...that he had stolen property from Fahnestock." Fahnestock's former managing director testified that the amended

Form U-5 was filed at the command of Fahnestock's chairman for the specific purpose of damaging Waltman's reputation rather than for a regulatory purpose. Additionally, evidence was introduced that Fahnestock attempted to force Waltman to drop his counterclaim by threatening his current employer.

The Second Circuit found that New York Law applied and that under New York law a communication is entitled to a qualified privilege where it is fairly made by a person in the discharge of some public or private duty, legal or moral, or in the conduct of his own affairs in a matter where his interest is concerned. But the court held that, "The qualified privilege, however, can be vitiated upon a showing that the communication was made with actual malice (Citations omitted). Actual malice has been defined as `personal spite or ill-will, or culpable recklessness or negligence'" (Citations omitted).

2. Glennon v. Dean Witter Reynolds, Inc

Glennon v. Dean Witter Reynolds, Inc., 83 F 3rd 132 (6th Cir 1996), is an example of the type of case where defamation claims are sustained. The unpublished decision of Thomas A. Wiseman, Jr., U.S. District Judge, gives the background. The litigation was the result of a motion by defendant Dean Witter to vacate an NASD arbitration Award. Glennon had been a branch manager in Dean Witter's national office and was subsequently fired. Dean Witter filed a Form U-5 that indicated he was under investigation for fraud or wrongful taking of property at the time of his termination and added that,

> Mr.Glennon was terminated as an employee of the firm as a result of his refusal to repay monies he was paid inadvertently over a period of several months, monies to which he had no entitlement.

The court specifically found that in fact there was no such investigation ongoing at the time of Mr. Glennon's termination and that while Glennon had accidently been overpaid, he had explained that he was retaining the money with the intention of setting it off against a greater sum of money he believed Dean Witter owed him from a recruitment bonus and a finder's fee. The latter claim was in dispute at the time the U-5 was filed and was resolved in Glennon's favor by the arbitration panel.

There were many claims resolved in Mr. Glennon's arbitration. For example, he claimed that his firing was a retaliatory discharge because of his whistle blowing activities in reporting ethics violations on the part of several brokers working under him. This claim was dismissed by the panel. The panel also ordered Glennon to repay the overpayment he had received. However, the arbitration panel did order Dean Witter to pay Glennon the recruitment bonus and the finder's fee. It ruled that the statements explaining Glennon's termination in the Form U-5 were defamatory and awarded him $1.5 million in compensatory and punitive damages, and $213,000 in attorney's fees. It also ordered Dean Witter to amend the Form U-5 to remove the defamatory explanation of Glennon's termination and replace it with an explanation that he had been terminated as a result of

a compensation dispute.

One of the grounds on which Dean Witter moved to vacate the arbitration award is interesting because it smacks of desperation. Dean Witter claimed that the chairman of the panel had a bias against the ethnicity of one of the defendant's witnesses, a Mr. Olsen. This claim, which was never made on the record during the arbitration proceeding, was based on some statements of the chairman during Mr. Olsen's testimony, to the effect that it was a cultural characteristic of Scandinavian Americans to answer questions tentatively, preceding statements with phrases like, "I think" or, "It might".

The district court dismissed this claim and found that from the record it appeared that the statements were made by the chairman to stop the plaintiff's attorney from badgering the witness for a yes or no answer during his examination rather than as a reflection of any anti-Scandinavian bias.

The parties' briefs argued a very narrow issue of whether statements in the Form U-5 are entitled to an absolute privilege under Tennessee law. Dean Witter argued that the Restatement Second of Torts § 592A, which provides that, "one who is required by law to publish defamatory matter is absolutely privileged to publish it," was controlling. Additionally, they placed great reliance on the Hertzfeld & Stern case and the Tennessee case of Lambdin Funeral Service, Inc. v. Griffith, 599 S.W. 2nd 791 (Tenn. 1978), in which the Tennessee Supreme Court applied an absolute privilege to statements in an administrative proceeding and in pleadings filed before the Tennessee Board of Funeral Directors and Embalmers.

Glennon argued that defamatory statements on a Form U-5 are actionable and are protected by a qualified privilege at most. He cited Fahnstock as well as Flek v. E.F. Hutton, Inc., 891 F 2nd 1047 (2nd Cir. 1989), which held that defamation claims based on statements made on Form U-5 are arbitrable. Glennon also argued that the Baravati case was on his side.

In seeking to argue away the Hertzfeld v. Stern decision, labeling it a "faulty analysis of controlling New York law," Glennon asserted that it relied on the New York Court of Appeals decision in Toker v. Pollak, 44 N.Y. 2nd 211 (1978), and that Toker was misconstrued by the Hertzfeld v. Stern court.

On May 6, 1996, the Sixth Circuit affirmed the lower court, which had affirmed the arbitration Award. The Sixth Circuit stated that whether a Form U-5 is entitled to an absolute privilege turns on whether it is part of a judicial or administrative proceeding. The court then went on to find that the submission of a Form U-5 is not part of the NASD's quasi-judicial regulatory process and that although the Form U-5 can trigger an investigation of a member or broker, and may be used as evidence in a disciplinary proceeding, it is not part of a judicial proceeding. Thus the court held that the Form U-5 is not entitled to an absolute privilege.

3. Baravati v. Josepthal, Lyon & Ross

In Baravati v. Josepthal, Lyon & Ross, 28 F. 3rd 704 (7th Cir. 1994), the Seventh Circuit found that a Form U-5 is not absolutely privileged as a communication made in a judicial or quasi-judicial proceeding so as to insulate the drafters from liability for defamation. The Court found that a securities firm has only a qualified privilege to defame an employee which is forfeited if the firm knows, or is reckless in failing to discover that it is defaming the broker falsely.

The Court noted that the NASD requires that whenever a broker is terminated a Form U-5 must be submitted to the NASD. The NASD retains and makes available such form to any member who wants information about the broker, said the court, perhaps because he has applied for a job.

Josepthal, Lyon & Ross (hereinafter "JLR") listed the reason for Baravati's termination as "under investigation for the fraudulent and wrongful taking of firm property in the amount of $7,650.25."

In his arbitration claim, Baravati contended that the reason stated in the Form U-5 for firing him was false and defamatory and that, in fact, he had been fired in retaliation for blowing the whistle to the SEC about fraud committed by JLR on it's customers. The arbitrators found that he had been defamed and awarded him $60,000 in compensatory damages and $120,000 in punitive damages. Baravati went to District Court to enforce the Award.

The firm argued for an absolute privilege for the contents of Form U-5 on two grounds. First they argued that Baravati waived his right to complain about being defamed by signing a Form U-4. The court found such "consent" argument was frivolous and need not be discussed. Then JLR argued that they were entitled to an absolute privilege because the U-5 was a judicial or a quasi-judicial communication and the court held against them. The Court found that Form U-5 has only a qualified privilege under Illinois law, citing Mittelman v. Witous, 135 Ill. 2nd 220 (1989). The Seventh Circuit affirmed the decision of the District Court, which had affirmed the arbitration Award.

4. Kurschus v. Paine Webber

In Kurschus v. Paine Webber, 1996 WL 389303 (S.D.N.Y.), the court described the background of the litigation as follows:

> Plaintiff commenced this action against defendant Paine Webber, among others, on March 9, 1995. Plaintiff's initial complaint asserted claims for relief against defendant Paine Webber for sexual harassment, malicious prosecution, negligence, and conspiracy. These claims arose from the following events during plaintiff's

> employ which ultimately led to his termination. On May 17, 1994, plaintiff was arrested and imprisoned in Nassau County on sodomy charges brought against him by his supervisor at Paine Webber and his supervisor's wife. On December 27, 1994, a grand jury refused to indict plaintiff on a charge of sodomy in the First Degree. On June 8, 1995, plaintiff and defendant stipulated that all of plaintiff's claims (in his initial complaint) against defendant would be sent to binding arbitration before the NASD; pending arbitration, adjudication of these claims has been stayed.
>
> On or about June 10, 1994, given the opportunity to resign voluntarily, plaintiff terminated his employment. At this time, Paine Webber agreed that Plaintiff's Form U-5 [footnotes omitted] would reflect his voluntary resignation...
>
> ...In a June 14, 1994 alleged termination agreement, defendant Paine Webber informed plaintiff that "Paine Webber does not consider the criminal proceedings in Nassau County as involving any 'investment-related' conduct on the part of Mr. Kurschus or 'investment-related business' within the meaning of Items 13, 14, and 15 of Form U-5." Items 13, 14, and 15 serve to notify potential employers of the terminated individual's past acts which qualify as "statutory disqualifications" – acts which, if unrelated to investments, reach the level of felony conviction, and bar that individual from working with a member firm.
>
> On June 27, 1994, plaintiff received a copy of the Form U-5 filed by Paine Webber, in which plaintiff's resignation was designated "voluntary," questions 13, 14, and 15 were answered in the negative, and no reference to the Nassau County proceeding was made. Three days later, on June 30, 1994, Paine Webber filed an amended Form U-5 which included a "yes" answer to question 13(c)(1) and details reflecting Kurschus's arrest.
>
> Paine Webber added a comment under Form U-5's allegations section: "On 5/14/94, plaintiff was charged with Sodomy, a class B felony and arrested on 5/18/94." Plaintiff was not informed of this amendment until on or about September 1995, a few weeks after commencing a new job at a different brokerage house. At that time, because of defendant Paine Webber's comments on his Form U-5, plaintiff's new firm suspended plaintiff from its employ until a "clean" Form U-5 was filed. In response to demands from plaintiff's counsel, on or about November 7, 1995, Paine Webber amended the Form U-5 yet again. Question 13(c)(1) was answered "no." However, Paine Webber further noted, "On June 30, 1994, Paine Webber electronically filed an amended Form U-5...at the direction of the NASD in relation to charges filed against Mr. Kurschus...for a class B Felony of Sodomy. Mr. Kurschus was subsequently dismissed of all charges."

The court's holding was brief:

> A. Libel Claim
> Form U-5 does not seek disclosure of arrest, arraignment or indictment of a

criminal offense--it is limited to convictions or pleas of guilty or nolo contendere. In light of this fact, plaintiff contends that defendant's affirmative response to question 13(c)(1) and its "gratuitous" comments regarding plaintiff's charge and arrest on the Form U-5 filed on June 30, 1994, were made maliciously in order to hinder plaintiff's prospective employment in the securities industry. Plaintiff's allegations state a viable cause of action for libel.

C. The Scapegoat Cases

Two very recent cases appear to show the antagonism of courts to the potential use of Form U-5 to pillory scapegoats and the sometimes difficult task of accurately filing Form U-5's in the context of class actions resulting from the sale of brokerage firm in-house partnerships and other proprietary products. These are Dawson v. New York Life Insurance Co., 932 F. Supp. 1309 (N.D. Ill 1996), decided July 19, 1996 (and currently on appeal) and Prudential Securities v. Dalton, 929 F. Supp. 1411 (N.D. OK), decided April 18, 1996. In both these cases the plaintiffs were former managers (Dawson of a New York Life insurance branch and Dalton of a Prudential brokerage branch) and in both cases the allegedly defamatory amendments to the Form U-5's were filed selectively.

1. Dawson v. New York Life Insurance

Ronald Dawson was the general manager of New York Life Insurance's Corpus Cristi, Texas, general office from August 1985 to September 1989. He started out doing very well with New York Life. The court found,

> "Throughout his career with New York Life, Dawson was promoted to positions of greater and greater responsibility based on his performance as an agent and manager. In 1981 after previously serving as an agent and assistant manager he was promoted to general manager....Dawson's transfer to Corpus Cristi was initiated by three senior New York Life officers. New York Life chose Dawson to manage the Corpus Cristi office because the company wanted a strong recruiter of agents in that office and Dawson was so regarded. When Dawson arrived in Corpus Cristi there were approximately 38 agents in the office; when he left Corpus Cristi in 1989 there were 126 agents working out of that office. Dawson received numerous awards while general manager of the Corpus Cristi office. His office was selected as a field project location in connection with the agency home office management school–which is considered an honor. In 1987, Dawson's immediate supervisor, Ernestine Beauchamp, who was then regional vice president, referred to Dawson as `the number one general manager' in the southwest region.
>
> Effective September 1, 1989, Dawson was transferred to the Oakbrook, Illinois, general office where he worked as that office's general manager. Dawson continued to earn awards and honors while general manager of the Oakbrook office. He traveled nationwide speaking on behalf of the company at training seminars and regional management schools. In 1990 Dawson was elected to speak at the company's national managers meeting--which is considered an honor. For

> the year 1992 Dawson earned two major production awards for his performance as Oakbrook general manager, which he was scheduled to receive at the company's 1993 national managers meeting. On February 14, 1993, the same day that company officers decided to fire him, Dawson was speaking at a regional managers meeting in Chicago."

The reason Dawson was fired was that in February of 1993, a State Court jury in Corpus Cristi, Texas, found that New York Life Insurance Company and one of it's agents breached their duty of good faith and fair dealing, breached their fiduciary duty, and committed false, misleading or deceptive acts in connection with certain transactions involving a policy holder and his wife. The jury also found that New York Life committed fraud in connection with these transactions and awarded $65,000 in pecuniary losses, $1,000,000 for mental anguish and $15,000,000 against New York Life as punitive damages. This was the first punitive damages award against New York Life in its 150 year history.

The Dawson court's decision was in response to defendant's motion for summary judgment dismissing Dawson's complaint. The standard of review was such that each and every allegation by Dawson had to be given credence. The case was submitted to the court on the basis of several stipulations of fact.

New York Life had filed a U-5 with respect to Dawson's termination on February 25, 1993, and then amended it on three further occasions.

The amendments and the cause of action related back to the above-referenced case in Corpus Cristi which resulted in the punitive damages award. In that case an agent named Herrera had indulged in a practice called "windowing", which was basically tracing someone's signature onto a form converting the insurance policy to whole life instead of term insurance. The forgeries resulted in substantially increased commissions and credits to both the agent and the agency.

The Texas court found that Herrera and certain others at the New York Life office engaged in forgery, "windowing", and other deceptive practices. As the court put it, "Of relevance to Dawson's present defamation action against New York Life, is the testimony presented at the Hernandez trial concerning the Corpus Cristi office management's awareness, if not authorization of, and participation in, misconduct by agents and employees of that office. Indeed there was substantial evidence of such misconduct and of management's awareness, authorization, and participation in it. The evidence of misconduct in the Hernandez testimony centered around agents' unauthorized conversion of insurance policies (usually from term insurance to permanent insurance), forgery of policy holders signatures, and unauthorized commission switching."

However, the actual evidence against Dawson himself was very flimsy. In the plaintiff's closing argument in the Hernandez case, the attorney argued that a certain letter

constituted circumstantial evidence that Dawson was "in on" the forgery. However, in fact, the attorney's closing had overstated the evidence.

Thereafter, the Hernandez's attorney mailed letters to New York Life seeking settlements with respect to two other claimants who had allegedly been the subject of similar corrupt practices. In response to these letters, New York Life filed additional U-5s against Dawson, in effect stating that he was in on the first fraud as well as the second and third.

However, the Dawson Court found it to be undisputed that there was no testimony that Dawson knew of or participated in the Hernandez fraud or the other two instances. In fact the plaintiff's attorney actually provided a letter, which in effect recanted his closing argument, admitting that there was no evidence against Dawson.

But that was not all. New York Life not only filed U-5s asserting the nefarious behavior of Dawson, but actually used him as an example in several company-wide speeches and prepared a substantial videotape describing the frauds allegedly committed by him and making the viewing of such tape a requirement for all of the New York Life agents nationwide. Truly this is publication of a defamation.

In an attempt to dismiss Dawson's claim, first New York Life argued they were entitled to an absolute privilege because they were only reporting on the U-5s the result of a judicial proceeding. The court found that such privilege attaches only if the reporting of the judicial proceeding is accurate and that in this case it was not accurate. The court also noted that no one from New York Life contacted Dawson in an effort to verify the truth of the various things that were said about him. Of particular importance in the scapegoat context, the court noted that New York Life was selective in its filing of Form U-5s. They did not file any Form U-5s against two other former registered employees who were involved in the same fraud.

The court decided that Illinois law governed; even though the actions took place in Texas, the defamatory statements took place in Illinois. The court agreed with New York Life's argument that their statements were conditionally privileged because of the common law privilege to make statements in their interest or the interest of a third party. However, the court also found that the right to a qualified privilege can be vitiated by abuse of the privilege and held that the question of whether the qualified privilege had been abused was a question of fact for the jury.

The court ruled against New York Life's motion for summary judgment and the case went to trial. In November 1996, a Federal jury awarded $6.3 million to Mr. Dawson because he had been defamed by the company. The jury found Dawson should receive $1.3 million in actual damages and an additional $5 million in punitive damages. This case is currently on appeal to the Seventh Circuit.

The main issue on appeal is "Whether the trial court erred by instructing the jury that a former employer's reporting of a customer complaint in connection with NASD Form U-5 must include disclosure of all 'relevant information' available to that company including 'all facts that would lend support to or cast doubt on the truth of the allegations' of the customer complaint." The NASD, the Securities Industry Association and the American Council of Life Insurance have all submitted amicus briefs arguing against that proposition, i.e., that the court's holding is over broad and puts a tremendous burden on the industry which obviates the instructions and the computer design of the CRD. The essence of their amicus positions does not address the issue of defamation; it focuses on the newly created and burdensome obligation to provide all "relevant information"..

2. Prudential Securities v. Dalton

The Dalton case is most interesting in the context of brokerage firms' proprietary products; another person victimized by the Prudential limited partnerships scandal. This time, however, it wasn't a customer.

Dalton had served as the office manager of the Tulsa, Oklahoma, branch of Prudential from January 1983 through July 1989, when he voluntarily resigned after having been demoted in March 1988. When he resigned, Prudential filed an innocuous Form U-5.

In early 1991 a former client of Prudential filed a Statement of Claim in an arbitration before the NASD against Prudential, Dalton, two subsequent branch managers of Prudential's Tulsa office, and a Prudential account executive. The claim alleged that (1) the account executive sold unsuitable investments, (2) Prudential, Dalton and the two subsequent branch managers had failed to supervise the account executive, and (3) Prudential breached its fiduciary duty and engaged in an ongoing fraud. These allegations were based on, among other things, the purchase of various limited partnerships through Prudential.

The court noted that Prudential had entered into class action settlements as well as a settlement agreement with the SEC with respect to the partnerships. The court further found that in June 1992 Prudential was well aware of the investigations being conducted by the NASD and the SEC with respect to its limited partnerships.

The customer's arbitration claim was settled by Prudential for the sum of $137,000. Neither Dalton nor the two subsequent Prudential branch managers contributed to the settlement. As a result of the settlement Prudential filed an amended U-5 against Dalton. But no amendments were filed on the U-5s of the subsequent branch managers. This sort of selective filing riled the court.

The court noted that prior to filing an amended U-5, Prudential wrote to Dalton's counsel and provided them with a Disclosure Reporting Page supposedly in draft form. However the draft was very different from the one that was ultimately filed.

As a result of the amendments, Dalton brought a claim in arbitration alleging defamation. Prudential made a motion (within the arbitration process) to dismiss, which the arbitrators, by a two to one vote, granted (according to the court -- the Award shows no dissent). Dalton then took his case to, federal district court to vacate the panel's dismissal of his action.

Dalton's claim, it would seem, is one that could be made by any good broker in a firm whose proprietary product of the 1980s or early `90s yielded bad results. The Court said,

> A fundamentally fair hearing requires the procedural steps of notice, an opportunity to be heard, the opportunity to present evidence which is relevant and material, and arbitrators who are not infected with bias. [citation omitted]
>
> Dalton's contention is that untrue stigmatizing information was placed in the Amended U-5 by Prudential and filed with the NASD. Specifically, that which Dalton contends is stigmatizing in the Amended U-5 states the Lytle claim "was settled or decided against the individual (Dalton) for $5,000.00 or more, or found fraud, or the wrongful taking of property."
>
> Dalton contends that while it is true $137,000.00 was paid by Prudential in settlement of the Lytle claim, he paid nothing, and any fraud involved was that of Prudential, not him. He further asserts that the untrue statement in the public document directly implicates him in precipitating the settlement, or that he was in some way guilty of fraud, and blackballs him in the securities industry from achieving a managerial position in the future. Dalton contends his former employer, Prudential, intentionally falsified the Amended U-5 to deflect attention from Prudential, who at that time was being investigated nationwide for fraud in urging their local managers and account executives to sell the subject limited partnerships sponsored by Prudential.

The court then overturned the arbitration panel's dismissal. In a very succinct holding the court stated:

> Before an arbitration panel should be able to dismiss a claim for failure to state a cause upon which relief can be granted, the claim should be facially deficient. Such is not the case here for if the allegations of the claimant's complaint are taken to be true, he would be entitled to some form of relief, even if it were limited to requiring Prudential to file a second Amended U-5 to set out the true nonstigmatizing facts. Thus, to assure fundamental fairness, claimant is entitled to offer evidence relevant to his claim.

The court went on to discuss Prudential's assertion that it was protected by absolute privilege. The court, citing Baravati, held that qualified privilege is the better view and also conformed to state (Oklahoma) law. Another interesting sidelight: Prudential urged a one year statute of limitations – the Oklahoma statute on defamation. But the court found that the arbitration claim sounded in breach of fiduciary duty and tortious interference with economic advantage, each of which had two year statutes under the law of Oklahoma.

XI. Conclusion and A Modest Proposal

Defamation claims based on Form U-5 filings have been given credence by courts and arbitrators. According to information presented at the 1997 Securities Industry Institute (an annual program held at The Wharton School at the University of Pennsylvania, sponsored by the Securities Industry Association), brokers have won 260 arbitration Awards involving defamation claims. Whatever the case law, it is clear that arbitrators do not think there is an absolute privilege because brokers are reported to have won their claims 75% of the time in Florida; 71% of the time in Pennsylvania; 67% of the time in Texas; 64% of the time in New York; and, 47% of the time in California.

It is this author's opinion that U-5s should be allowed only a qualified privilege vitiated by malice or abuse. To hold otherwise is to countenance vengeance run riot. Practitioners bringing such claims should be very careful in studying the ancillary issues relating to the appropriate statute of limitations and the companion claim of tortious interference.

A modest proposal to avoid many more filings, litigations and arbitrations such as Dalton appears in order with respect to firm sponsored or proprietary products. It is suggested that if brokers followed instructions and made representations dictated by selling sheets provided by their firms when they made sales of limited partnerships or other proprietary products, the firms and the NASD should carve out an exception so that such activity (even if it comes from claims from customer claims) should not be entered on the broker's U-4 or U-5. This should be especially so in situations like Dalton, where the firm alone settled with the customer and paid the claim without input or contribution from the broker.