Steering Around Defamation Liability When Completing a U-5

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Terminating a registered representative can be a difficult, contentious process leaving both parties feeling battered. Filing a U-5 and describing for third party consumption the reasons for the termination can exacerbate those feelings, particularly when the description paints an unflattering picture of the terminated representative. Not surprisingly, there are often conflicting versions of the events leading up to a termination. If U-5s remained private, those disagreements would probably not amount to much. But an unfavorable U-5 follows a terminated representative and can hamper his ability find new clients and new employment in the securities industry. Those factors give terminated registered representatives a powerful incentive to fight what they perceive to be misrepresentations or mischaracterizations on their U-5s. Historically, one way they have fought back is via defamation claims against the broker-dealers who filed the disputed U-5s. Broker-dealers would obviously prefer to close the door on the terminated representative and move on. Thus, the question for broker-dealers is how to file a U-5 that avoids giving a terminated representative ammunition for a defamation lawsuit? This Article sets out four guiding principles for completing U-5s. The principles are common-sense based and admittedly not revolutionary, but to fully appreciate their worth it helps to know a little about what constitutes a defamatory statement and the privilege that broker-dealers enjoy when it comes to U-5 submissions. This Article discusses those issues following a brief review of the U-5 and its uses.

I. Background and Use of the Form U-5

The U-5 is the standard form used in the securities industry to report the termination of a representative's association with a broker-dealer. Under FINRA rules, broker-dealers must file a U-5 within thirty days of an individual's termination. At the same time, the broker-dealer also must provide a copy of the U-5 to terminated individual.

The U-5 requires broker-dealers to answer a series of questions concerning a representative's termination. A broker-dealer is required to declare whether the nature of a termination was voluntary or whether an individual was discharged, permitted to resign, died, or "other." If the termination was due to anything other than the representative's death or voluntary decision to leave, the broker-dealer is required to elaborate in writing. More significantly, broker-dealers must also advise whether a terminated representative was:

(1) the subject of an investigation by a governmental body or self-regulatory organization concerning investment-related business;
(2) under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules, or industry conduct standards;
(3) charged, convicted, or pleaded no contest to any felonies, or to certain misdemeanors;
(4) the subject of any disciplinary action by a governmental body or self-regulatory organization with jurisdiction over investment-related business;
(5) named in customer-initiated arbitration or civil action alleging he engaged in certain sales practice violations; or
(6) discharged, permitted to resign, or voluntarily resigned after allegations were made accusing the representative of fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules, or industry conduct standards, or failing to supervise in connection with investment-related statutes, regulations, rules or industry conduct standards.

In the event any of the foregoing applies, the broker-dealer must elaborate by completing and submitting additional Disclosure Reporting Pages.

For a terminated representative, one of the most troubling aspects of a disparaging U-5 is its effect on his ability to attract clients. While FINRA limits public access to some of the information on a U-5, regulators in several states make the information freely available to the public on request. An unflattering U-5 can also make it difficult for the terminated representative to find other jobs in the securities industry because broker-dealers considering hiring the terminated representative are required take the information on a U-5 into account when hiring. Moreover, the only way a terminated representative can *compel* changes to a U-5 is to bring a defamation action against the broker-dealer that filed it.[1]

II. Defamation in a Nutshell

A statement is defamatory if it has the potential to harm a person's reputation by either: (1) deterring third persons from associating or dealing with him; or (2) lowering the esteem in which he is held in the community.[2] To be clear, a statement can be defamatory *and* true. When it is, the defamed party cannot recover for the defamation. Thus, a party can only recover damages if a statement is both defamatory and false.[3] Moreover, broker-dealers enjoy an additional level of protection from defamation claims arising out of the statements in a U-5. The extent of that protection remains a matter of some dispute, but it is clear that, at a minimum, broker-dealers will only be liable for false and defamatory statements if they *knew* the statements were false or if they *recklessly failed to determine* whether the statements were false.

III. Privilege to Make Defamatory Statements

There are two schools of thought as to how much protection broker-dealers should receive from claims arising out of the disclosures in a U-5. One school argues broker-dealers' disclosures are "absolutely privileged" and, therefore, they cannot be liable for any defamatory statement made on a U-5.[4] The other school argues broker-dealers' disclosures enjoy only a "qualified privilege," and that a broker-dealer can be liable for defamatory statements on a U-5 if it knew or recklessly disregarded the falsity of the statements.[5] Both schools of thought agree that the public has a strong interest in ensuring regulators like FINRA are aware of and able to investigate and adjudicate charges of misconduct by registered representatives. As a result, both schools agree on the need for candid disclosure of the grounds for a representative's termination. What the two schools disagree on is whether the public's interest in unvarnished disclosures is so strong that it overrides the representatives' interests in remedying any false

statements on a U-5 that could damage their professional reputations or careers.

A. Arguments Favoring an Absolute Privilege

The law recognizes an absolute privilege to defame "where society's interest in the free flow of a particular type of information is so strong" that it is important to ensure civil liability for defamation does not discourage the communication of that information.[6] U-5s are an important part of FINRA's oversight of securities industry personnel. According to FINRA, "[c]andid and accurate disclosure of a regulatory or disciplinary problem that contributed to an employee's termination is critical to ensuring that prospective broker/dealer employers make informed hiring decisions and establish appropriate supervisory systems."[7] Proponents of the absolute privilege argue the best way to ensure the "candid and accurate disclosure[s]" FINRA seeks is to provide broker-dealers blanket immunity from all liability arising out of a contested U-5 filing. Under this approach, a broker-dealer's intent, good faith, and/or motive in filing the U-5 are irrelevant. Anything less, according to its proponents, discourages full disclosure.[8] Furthermore, the proponents argue, it is simply unfair to require broker-dealers to make the publicly desirable disclosures required by U-5s and then force them to bear liability for it.[9]

B. Arguments Favoring a Qualified Privilege

A "qualified privilege" to defame represents the law's attempt to balance the public interest in promoting disclosure of certain information against the interests a defamed person has in protecting his reputation.[10] Stated differently, a qualified privilege to defame is recognized where the interest in protecting the free flow of information is strong but not sufficiently compelling to justify protection for speakers who defame because of improper motives or in an egregious way.[11] Where a speaker knowingly makes a false and defamatory statement or is reckless about whether his defamatory statement is false, he loses the protection of the privilege and can be liable for the harm his statement causes.[12]

Proponents of a qualified privilege focus on the potential unfairness of the absolute privilege. They argue the danger of applying an absolute privilege is that it would "insulate [broker-dealers] from liability for the contents of their U-5s [and] would be tantamount to allowing a member of the NASD to blackball a former employee from employment" in the securities industry.[13] A qualified privilege, on the other hand, balances the interests of broker-dealers by largely protecting them from liability for defamatory statements but at the same time protecting registered representatives against outright falsehoods that injure their reputations and imperil their careers.[14]

IV. Statutes and Case Law Overwhelmingly Favor a Qualified Privilege

Most of the jurisdictions that have addressed this issue, whether through statutes or case law, have rejected the absolute privilege in favor of a qualified privilege. Fifteen states and the U.S. Virgin Islands have adopted the 2002 version of the Uniform Securities Act drafted by the National Conference of Commissioners on Uniform State Laws.[15] That Act provides qualified immunity to persons who make defamatory statements in connection with a filing like the U-5 that is required by law or industry rules.[16] Courts in fourteen states have considered whether to apply an absolute or qualified privilege to U-5 statements.[17] Of those states, only courts in New York and California have held that broker-dealers enjoy an absolute privilege to defame terminated representatives in a U-5.[18] In all, the case law and/or statutes[19] in twenty-three of the twenty-five states that have considered the issue give broker-dealers a qualified privilege for the statements made in U-5 submissions.

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V. Guiding Principles for Completing U-5s

Because the overwhelming trend is to afford broker-dealers a qualified privilege for the statements made in a U-5 filing, the principles below speak to the completion of U-5s in jurisdictions where a broker-dealer's statements are subject to the qualified privilege.

A. You CAN Handle the Truth!

It goes without saying that the statements in a U-5 must be truthful. FINRA requires broker-dealers to confirm at the time they sign a U-5 that there is factual support for the statements and representations in the filing. Section 8A of the Form states that the person signing for the broker-dealer "verif[ies] the accuracy and completeness of the information contained in and with" the U-5. Beyond that obligation, however, ensuring the statements in a U-5 are truthful will limit the number of defamation actions the broker-dealer has to defend.

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Furthermore, getting the facts right – or as right as possible in the event an investigation, review, or legal proceeding is ongoing – at the time the U-5 must be filed will help a broker-dealer ensure its ultimate success in the event it is forced to defend itself from a defamation claim. Finally, being able to demonstrate factual support and a reasoned basis for the statements in a U-5 is helpful even if the statements turn out to be false. As noted above, a broker-dealer is not liable under the qualified immunity standard simply because some of the U-5's statements were false. It is only liable if it made the statements with knowledge that they were false and/or acted recklessly in determining whether they were false.[20] Diligently confirming the information in a U-5 will help demonstrate that the broker-dealer's defamatory statement was not knowingly or recklessly false.

B. Keep Emotions Out of It.

A contentious termination can leave all parties feeling raw. Consequently, there can be an enormous temptation to use a U-5 to make (or score) points that are not strictly relevant to the reasons behind the termination. That temptation must be resisted. Vanilla is truly the finest of the flavors when it comes to completing a U-5. The impression one should have after reading a U-5 is that it was written by Mr. Spock; *i.e.*, the statements in the U-5 are totally devoid of emotion. Readers will intuitively pick up on the emotion in a writing. Experience teaches that the more emotional a writing is, the more likely it is to contain exaggerations or embellishments. Furthermore, the more emotion there is in a U-5 disclosure, the easier it is for an arbitrator, judge, or jury to believe the decision to terminate was driven by emotional factors as opposed to the business justifications set forth in the U-5.

C. Keep It Short.

The explanatory sections of a U-5 should be as concise as possible and convey only the information required. As a general rule, the shorter the explanation is, the more likely it discusses only those facts that are relevant to the termination, which limits the likelihood the U-5 will contain false or inaccurate statements that could serve as the basis for a defamation claim.

D. A Broker-Dealer Must Make Sure It Fulfills Its Duties to Disclose.

Accurate, unemotional, and short are important for minimizing exposure to defamation claims, but a U-5 submission must still satisfy FINRA's disclosure requirements. A broker-dealer concerned about having to fight a defamation claim might be tempted to "whitewash" a terminated representative's U-5. Failing to accurately disclose the grounds for a representative's termination can give rise to liability from the representative's subsequent employers[21] and the representative's subsequent clients. In addition, the broker-dealer could face regulatory fines and penalties for failing to fully and accurately disclose the facts surrounding a representative's termination.[22]

The decision in *Twiss v. Kury*[23] is an example of the liability a broker-dealer could face for an inaccurate and/or incomplete disclosure. E.F. Hutton, the broker-dealer in that case, discovered its representative had accepted money from several clients in exchange for promissory notes, violating the broker-dealer's and industry rules. E.F. Hutton allowed the representative to resign and reported it had no reason to believe he violated any state or federal law or engaged in conduct inconsistent with just and equitable practices. Years later, a state administrative agency accused the registered representative of operating a Ponzi scheme based on the same conduct that lead to his "resignation"

from E.F. Hutton. The representative's customers argued the Ponzi scheme that robbed them of their investments could have been avoided if E.F. Hutton had fully and accurately disclosed the circumstances surrounding the representative's termination. The court agreed the broker-dealer had a duty under the state's securities laws to accurately report the grounds for the termination and that it could be liable to the investors for breach of that duty.[24]

A broker-dealer that fails to disclose all relevant factors concerning a representative's termination because of defamation concern is trading exposure to one form of liability for exposure to another. In light of that, the wisest course of action for broker-dealers is to fulfill their FINRA obligations and truthfully, accurately, and dispassionately disclose the information required by the U-5.

VI. Conclusion

Completing a U-5 is much more art than science. Having a better understanding of the factors by which the "art" is evaluated will hopefully help the reader perfect that art and better protect its broker-dealer from liability arising out of the statements in a U-5.

ENDNOTES

1 A terminated representative who registers with a new broker-dealer must file a Form U-4 and can at that time comment on the statements in his U-5. This, of course, assumes the terminated representative can find employment with a new broker-dealer; something an unflattering U-5 can make more challenging. *See* Anne H. Wright, *Form U-5 Defamation*, 52 Wash. & Lee L. Rev. 1299, 1306 n.29 (1995).

2 Restatement (Second) of Torts § 559.

3 Restatement (Second) of Torts § 581A, cmts. a and d.

4 *See Rosenberg v. Metlife, Inc.*, 866 N.E.2d 439, 442 (N.Y. Ct. App. 2007).

5 *See Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 708 (7th Cir. 1994).

6 *See* Wright, *supra* note 1 at 1326.

7 NASD Regulation Request For Comment 98-77.

8 NASD Regulation Request For Comment 98-77; Wright, *supra* note 1 at 1326.

9 *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d at 708 ("[S]ince the members are *required* to state the reason for termination on the U-5, denial of the privilege puts them in a hard place, where if they state a reason discreditable to the employee they may be sued for libel while if they lie about the reason they will be violating the association's rules.").

10 Restatement (Second) of Torts § 598, cmt. b.

11 Wright, *supra* note 1 at 1325.

12 Restatement (Second) of Torts § 600.

13 *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d at 708.

14 *Dawson v. New York Life Ins. Co.*, 135 F.3d 1158, 1164 (7th Cir. 1998).

15 Securities Industry and Financial Markets Association, State Issues: Model Uniform Securities Act, *available at* www.sifma.org/legislative/state/model-uniform.html (last visited May 25, 2010). The states are: Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, and Vermont.

16 Uniform Securities Act § 507 (2002), *available at* http://www.law.upenn.edu/bll/ulc/securities/2002final.htm (last visited May 25, 2010).

17 *See cases cited in* Terry R. Weiss and Nathan D. Chapman, *Permission to Be Frank? The Debate Continues Over an Absolute Versus Qualified Immunity in U5 Defamation Cases*, Securities Regulation & Law, vol. 39, No. 22, pp. 881-884 n.4 (June 4, 2007), *available at* http://www.sutherland.com/files/News/8444ad15-41-c1-445f-b85d- be53982e49c9/Presentation/NewsAttachment/f9819e05-0a39-4658-8ab1-8212afc6a928/LegalAlertLITPDFArtic6507.pdf. Courts in the following states addressed this issue following publication of the foregoing article: Colorado (*Crowe v. State Farm Mut. Auto. Ins. Co.*, Case No. 05 00858, 2007 WL 2126408 (Jul. 23, 2007)); Indiana (*Boxdorfer v. Thrivent Financial For Lutherans*, Case No. 09 0109, 2009 WL 2448459 (Aug. 10, 2009)); Maine (*Galarneau v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 504 F.3d 189 (1st Cir. 2007); Minnesota (*Nelson v. Wachovia Securities, LLC*, 646 F. Supp.2d 1066 (Aug. 10, 2009)); and Ohio (*J.J.B. Hilliard v. Reisen*, Case No. 09 535, 2010 WL 793850 (Mar. 2, 2010)).

18 *See Rosenberg v. Metlife, Inc.*, 866 N.E.2d at 442-43 and *Fontani v. Wells Fargo Inv., LLC*, 129 Cal. App.4th 719, 734-35, 28 Cal. Rptr.3d 833 (2005).

19 Five states have both: Indiana, Maine, Michigan, Minnesota, and Oklahoma.

20 *See Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d at 708.

21 *See Dawson v. New York Life Ins. Co.*, 135 F.3d at 1164 ("If the agent puts his new firm in jeopardy though fraudulent dealings or other malpractice, his new firm may sue the old one for failing to put the world on notice that the agent has a history of problems.").

22 *See* NASD Notice To Members 88-67 and Wright, *supra* note 1 at 1327 n.115.

23 25 F.3d 1551, 1556 (11th Cir. 1994).

24 *Id.*