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## Form U-5 Defamation

Anne H. Wright

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# Form U-5 Defamation

Anne H. Wright\*

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## *I. Introduction*

The extent to which securities professionals with significant disciplinary histories or multiple investor complaints manage to remain in the securities industry has attracted considerable attention in recent years. Members of the Securities and Exchange Commission (SEC) and officials of the various securities self-regulatory organizations (SROs) have expressed concern over the ability of some problem representatives to move from employment with

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one broker-dealer to another and have explored ways of protecting investors from such individuals.<sup>1</sup>

Oddly enough, for over a decade a reporting form has existed that was designed to offer regulators and potential employers a means of identifying problem representatives. The form, known as the Uniform Termination Notice for Securities Industry Registration (Form U-5) must be filed whenever an individual's employment with a broker-dealer is terminated.<sup>2</sup> The form requires the broker-dealer to report the reasons for the termination and whether the terminated individual had been accused of or found to have engaged in investment-related misconduct. The information reported on the Form U-5 is shared among national and state regulatory bodies and is made available to broker-dealers who consider employing the individual in the future. In theory, the wide availability of Form U-5 information should substantially limit the ability of problem representatives to remain in the securities industry

In practice, however, the Form U-5 has had limited efficacy as an early warning device. One of the most frequently cited explanations for this is broker-dealers' concerns about defamation liability if they report adverse information on the Form U-5.<sup>3</sup> In fact, some broker-dealers maintain —

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1. See generally Phyllis Diamond, *Special Report: "Rogue Broker" Problem Raises Troubling Issues for Firms, Regulators*, 26 Sec. Reg. & L. Rep. (BNA) No. 35, at 1207 (Sept. 2, 1994) [hereinafter *Rogue Broker Report*]; Commissioner J. Carter Beese, Jr., Remarks Before the Securities Industry Association 1993 Annual Convention 6-8 (Dec. 2, 1993) (copy on file with the *Washington and Lee Law Review*); *SEC Will Probe Smaller-Sized Firms, Levitt Tells House Rogue Broker Hearing*, 26 Sec. Reg. & L. Rep. (BNA) No. 36, at 1231 (Sept. 16, 1994); U.S. GENERAL ACCOUNTING OFFICE, SECURITIES MARKETS: ACTIONS NEEDED TO BETTER PROTECT INVESTORS AGAINST UNSCRUPULOUS BROKERS, GAO/GGD-94-208 (Sept. 14, 1994).

Between 1992 and 1993, the SEC staff conducted a review of the personnel retention and supervisory practices of the nine broker-dealers that carry approximately 49% of all public customer accounts in the United States. The review focused on 268 individuals who had been employed by one or more of these broker-dealers and who had been the subjects of sales-practice-related customer complaints or enforcement actions by securities regulators. The report concluded that, although there did not appear to be a pattern of movement by the 268 individuals among the nine firms studied, a significant number of the individuals were able to change employment despite multiple customer complaints. See SEC DIVISIONS OF MARKET REGULATION AND ENFORCEMENT, *THE LARGE FIRM REPORT: A REVIEW OF HIRING, RETENTION AND SUPERVISORY PRACTICES* 5 (May 1994) [hereinafter *LARGE FIRM REPORT*].

2. The term "termination" is used in a neutral sense both in the Form U-5 and in this Article. Accordingly, the term refers to any termination of a registered individual's employment for any reason.

3. See *LARGE FIRM REPORT*, *supra* note 1, at 10; *Rogue Broker Report*, *supra* note 1, at 1207-08, 1209. See also Edward Felsenthal, *Filings About Brokers' Departures from*

given the substantial defamation exposure that they may face if they accurately complete the Form U-5 — that it is wiser for them simply to give departing employees "clean" Forms U-5, whether warranted or not.

When this occurs, regulators do not receive accurate information about the reasons for terminations, prospective employers are not alerted to potential problems, and investors continue to be exposed to problem representatives. Further, such nondisclosure can subject broker-dealers to civil actions by subsequent investors who are injured by a problem representative or can result in SRO disciplinary actions against the broker-dealer. Thus, the proper handling of Form U-5 reporting presents a dilemma to broker-dealers: Those that fail to report accurately and completely the reasons for an individual's termination may face negligence or disciplinary actions, while those that respond accurately and completely to the Form U-5's questions may face defamation suits.

The concerns over potential defamation exposure are so strong that many broker-dealers maintain that candid Form U-5 reporting will not occur until such reporting is protected by either an absolute or qualified privilege against defamation liability.<sup>4</sup> Privilege supporters argue that the policies underlying existing common-law defamation privileges support a Form U-5 privilege, or that such a privilege should be created by statute, or by SEC or SRO rules.

This Article begins by briefly reviewing the background and uses of the Form U-5 before addressing the limited precedents in the area of Form U-5 defamation. Much of the concern over Form U-5 defamation awards has stemmed from an extremely small number of instances in which substantial damages were awarded in cases that involved relatively innocuous Form U-5 information. These cases, which have received substantial publicity, appear to form the basis for the perception that large Form U-5 defamation awards are routine in nonmeritorious cases.

The attention such cases attract is disproportionate to either the volume of defamation claims filed or to the number of defamation awards entered against broker-dealers to date. As discussed in detail below, the available information indicates that arbitration claims alleging Form U-5 defamation are not routine. Since 1989, arbitrators have issued awards in approximately fifty-five such cases. These awards represent an extremely small percentage

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*Firms Spark Libel Suits*, WALL ST. J., Apr. 14, 1994, at B10.

4. See C. Evan Stewart, *Disclosure of Bad Actors to Regulators: Matching Goals and Realities*, SECURITIES NEWS, Fall 1994, at 10, 11 (advocating statutory enactment granting absolute privilege); Rogue Broker Report, *supra* note 1, at 1207-08, 1209 (noting support for recognition of qualified privilege for Form U-5 information).

of the total number of arbitration cases handled by SROs. Moreover, although arbitration panels have on occasion directed broker-dealers to pay substantial damages for Form U-5 defamation, large awards are not the norm. Indeed, it is far more common for arbitrators to dismiss Form U-5 defamation claims or to direct that the form be amended without awarding any damages.

The five cases that have reached the courts to date follow a similar trend. Indeed, two of these cases have held that broker-dealers enjoy absolute immunity from liability for defamatory statements made in Forms U-5. Under these decisions, registered representatives are precluded from recovery for defamatory statements made on Forms U-5, even if the representative can demonstrate that the reporting broker knew that the information was false or otherwise acted maliciously.

Thus, as is the case in another controversial area — the debate over limiting punitive damages in civil litigation — isolated and atypical cases shape the perception that a drastic overhaul is needed. Overlooked is that a number of the Form U-5 defamation disputes have involved information whose falsity was known to the reporting broker-dealers, rather than inadvertent errors. Indeed, it is widely acknowledged that false Form U-5 reporting has sometimes been used to retaliate against departing employees<sup>5</sup> or threatened to gain concessions from such employees.<sup>6</sup>

Given such abuses, immunizing broker-dealers from all liability for defamatory Form U-5 statements would afford insufficient protection to the reputational interests of individuals employed in the securities industry. Any response to Form U-5 defamation concerns must balance these interests, regulators' need for accurate and complete information about the movements of problem representatives, and broker-dealers' desire for protection against civil liability for good-faith errors in Form U-5 reporting. In order to achieve such a balance, Form U-5 statements should enjoy only qualified immunity from defamation liability.

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5. See, e.g., Hugh H. Makens & Norbert F. Kugele, *Forms U-4/U-5 Disclosure: Compliance and Related Problems* (Part 2), NSCP CURRENTS, Sept./Oct. 1992, at 2, 3; Tad Leahy, *Marked for Life*, REGISTERED REPRESENTATIVE, Aug. 1990, at 24, 25.

6. For example, earlier this year, an arbitration panel awarded an individual \$625,000 in compensatory damages and \$1.25 million in punitive damages after finding that the content of the individual's Form U-5 was "improperly used" in negotiations over a severance package "in order to manipulate a settlement." *Ulrich v. Whitaker*, NASD Arbitration No. 93-281, at 4 (Jan. 11, 1995). See also Michael Siconofli, *Ex-Brokers Claim Prudential Changes Work Records*, WALL ST. J., Sept. 13, 1995, at C1 (discussing allegations that broker-dealer has filed derogatory amendments to Forms U-5 to retaliate against former employees who assisted customers in claims against broker-dealer).

## II. The Form U-5 and Its Use

The Form U-5 is the standard form used in the securities industry to report the termination of a registered representative's association with a broker-dealer. The form was developed jointly by the staffs of the SEC, the National Association of Securities Dealers, Inc. (NASD), the North American Securities Administrators Association (NASAA), and the various securities exchanges. NASD rules require that member firms file the form within thirty days of an individual's termination and update the form within thirty days of learning any information that renders the original filing inaccurate.<sup>7</sup> The NASD also requires member firms concurrently to provide terminated individuals with a copy of their Form U-5 and any amendments thereto.<sup>8</sup>

The portions of the form raising defamation concerns relate to the reasons for an individual's termination<sup>9</sup> and to indications of possible misconduct by the individual. Specifically, Question 13 of the form<sup>10</sup> asks whether, during employment, the terminated individual was:

[13(A)] involved in any disciplinary action by a foreign or domestic body or self regulatory organization with jurisdiction over investment-related business;<sup>11</sup>

[(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; [or] (2) was settled or decided against the individual for \$5,000 or more, found fraud, or the wrongful taking of property;

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7 NASD By-Laws, art. IV, § 3, NASD Manual (CCH) ¶ 1153, at 1050 (1995).

8. *Id.*

9. The form requires that terminations be classified in one of five categories: "voluntary," "deceased," "permitted to resign," "discharged," or "other." The last three classifications require an explanation.

10. As discussed in greater detail below, *infra* note 29, the Form U-5 is in the process of revision. When the revised form goes into use in 1996, the relevant questions will be renumbered as 13 through 18.

11. FORM U-5: UNIFORM TERMINATION NOTICE FOR SECURITIES INDUSTRY REGISTRATION 3 (Nov 1991). The Form U-5 defines "disciplinary action" as the "denial, revocation, or suspension of a registration, or a censure, fine, cease-and-desist order, order of prohibition, temporary restraining order, injunction, bar, or expulsion." *Id.* at 2. The term "investment-related" is defined as "pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, investment company, investment adviser, futures sponsor, bank, or savings and loan association)." *Id.*

[(C)] convicted of, or pleaded guilty to or *nolo contendere* 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, bribery, forgery, counterfeiting, extortion, or gambling; or (2) any other felony<sup>12</sup>

In addition, Questions 14 and 15 of the form require broker-dealers to report whether, at the time of termination or submission of the Form U-5, the terminated individual was:

[14] involved in an investigation or proceeding<sup>13</sup> by a domestic or foreign governmental body or self regulatory organization with jurisdiction over investment-related businesses; [or]

[15] under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct.<sup>14</sup>

An affirmative answer to any of the foregoing questions requires the broker-dealer to provide additional detailed information regarding each event, occurrence, proceeding, or investigation that necessitated the affirmative response.

The form is filed with the NASD, which 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 through 15.<sup>15</sup> 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<sup>16</sup>

The Form U-5 information is also entered into the Central Registration Depository (CRD), a computerized database that the NASD operates in con-

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12. *Id.* at 3.

13. The term "proceeding" as used in the Form U-5 includes formal administrative and civil actions initiated by SROs and governmental agencies and formal criminal charges. *See* NASD NOTICE TO MEMBERS 91-81 (NASD, Inc. Washington, D.C), Dec. 1991, at 451.

14. FORM U-5, *supra* note 11, at 3.

15. *See generally* NASD NOTICE TO MEMBERS 90-61 (NASD, Inc. Washington, D.C.), Oct. 1990, at 345-46.

16. In recognition of this fact, the NASD's two-year period to bring disciplinary action runs from the NASD's receipt of the Form U-5 or the last amendment thereto. *See* NASD By-Laws, art. III, § 6, NASD Manual (CCH) ¶ 1136, at 1048 (1995); NASD By-Laws, art. IV, § 4, NASD Manual (CCH) ¶ 1154, at 1051 (1995); NASD NOTICE TO MEMBERS 92-19 (NASD, Inc. Washington, D.C.), Apr. 1992, at 108.

junction with the NASAA.<sup>17</sup> The CRD maintains registration information concerning NASD member firms and their registered personnel for access by state regulators, certain SROs, and the SEC.<sup>18</sup> The CRD also contains information about regulatory and enforcement actions that these regulatory authorities have taken against broker-dealers and their registered personnel.<sup>19</sup>

The NASD views CRD information as a way to advise regulators of potential wrongdoing and to facilitate transfers of registered personnel from one broker-dealer to another. Although the NASD makes some CRD information publicly available,<sup>20</sup> neither Forms U-5 nor the full range of CRD information is publicly available through the NASD. Many states, however, treat the information as public, and release the full contents of an individual's CRD file on request.<sup>21</sup> As a consequence, in addition to being widely circulated among regulators, the contents of a Form U-5 sometimes can be obtained by members of the public, including a representative's current or potential customers. Adverse information reported on the form therefore can have a substantial effect on an individual's business reputation and livelihood.

However, even when Form U-5 information does not reach the general public, NASD rules require that Forms U-5 be provided to a representative's prospective broker-dealer employers and considered in the hiring process.<sup>22</sup>

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17 See Approval of Proposed Rule Change Relating to Release of Certain Information Regarding Disciplinary History, Exchange Act Release No. 30,629, 1992 WL 87786 (Apr. 23, 1992) [hereinafter Rule Change Relating to Release of Information]. The CRD was originally designed as a registration system to facilitate the licensing process with the states and the SROs. The system contains detailed information about more than 450,000 individuals. See LARGE FIRM REPORT, *supra* note 1, at 12.

18. See Rule Change Relating to Release of Information, *supra* note 17, at \*11 n.3.

19. *Id.*

20. Since 1988, the NASD has operated a public disclosure program whereby members of the public can obtain information regarding broker-dealers and their registered personnel. At present, members of the public can call a toll-free telephone number to obtain information on the following matters: pending and final disciplinary or enforcement actions by state and federal securities agencies and SROs; pending and final disciplinary actions by foreign governments and regulatory authorities; criminal indictments, informations, and convictions; civil judgments; and securities- or commodities-related arbitration awards in cases that were initiated by public customers. See generally LARGE FIRM REPORT, *supra* note 1, app. A at 7-8.

21. See Jane Bryant Quinn, *Brokers' Histories Should Stay Accessible*, WASH. POST, Oct. 8, 1995, at H2 (discussing public access to CRD information).

22. NASD rules require member firms to investigate the "good character, business repute, qualifications, and experience" of new hires. NASD Rules of Fair Practice, art. III, § 27(e), NASD Manual (CCH) ¶ 2177, at 2118 (1995). As part of this obligation to investigate qualifications, NASD member firms are required to obtain a copy of an individ-



Thus, the inclusion of negative information on the form can substantially affect an individual's prospects for continued employment in the securities industry. Even when adverse Form U-5 information does not prevent an individual from gaining further employment in the securities industry, such information will substantially slow the individual's registration with a subsequent broker-dealer employer.<sup>23</sup>

While few would dispute the appropriateness of requiring prospective broker-dealers to consider past investment-related misconduct in determining whether to hire an individual, the inclusion on a Form U-5 of false accusations of misconduct can have particularly unfair consequences to the affected individual.<sup>24</sup> The potential for unfairness is heightened by the limited oppor-

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ual's most recent Form U-5, plus all amendments thereto, within 60 days of filing a Form U-4 to register the individual. *Id.* at 2118. The Form U-5 may be obtained either from the individual or through the Firm Access Query System (FAQS), a service that the NASD makes available to NASD member firms. *Id.* If a prospective employer requests a copy of the Form U-5 directly from the individual seeking employment, the individual must provide the form within two days. *Id.* § 27(f), at 2118.

23. Affirmative answers on Forms U-5 preclude an individual from using the temporary agent transfer program (TAT) electronically to transfer registrations in the various states to a new broker-dealer. The individual who is unable to use TAT must undergo a thorough review in various states before transfer is permitted, and that person may be required to provide detailed information regarding misconduct suggested on the Form U-5 prepared by the previous employer. This process can take up to several months. *See generally Leahy, supra* note 5, at 24, 25.

The current TAT program will soon be replaced by a relicensing program as part of the CRD redesign described in note 29 *infra*. The new program will expedite registration transfers for most individuals, including some with affirmative answers to questions 13 through 15 on the Form U-5 or to question 22 on the Uniform Application for Securities Industry Registration or Transfer (Form U-4). Question 22 on the Form U-4 requires individuals who are seeking to register with a broker-dealer to report information similar to that reported by former employers on the Form U-5.

24. In 1989, the NASD began requiring that prospective employers receive past Forms U-5, recognizing that the circumstances surrounding a termination may be relevant in hiring decisions and should be readily available to NASD members for that purpose. *See NASD NOTICE TO MEMBERS 89-23* (NASD, Inc. Washington, D.C.), Mar. 1989, at 147. At the same time, the NASD recognized that providing broader access to the Form U-5 required that terminated persons be given the Form U-5 so that they could verify the accuracy and completeness of the contents of the form and advise prospective employers of any disagreement as to the accuracy of the form. *NASD NOTICE TO MEMBERS 89-57* (NASD, Inc. Washington, D.C.), Aug. 1989, at 313. Accordingly, the requirements that copies of the Form U-5 be provided both to terminated individuals and to prospective employers were added simultaneously. *See id.* Other SROs adopted comparable requirements one year later. *See generally Rule Change Relating to Exchange Rule 345 Regarding Employees — Registration, Approval, and Records, Exchange Act Release No. 28,367, 1990 WL 321546* (Aug. 23, 1990) (approving New York Stock Exchange's requirements).

tunities for individuals to respond to, or require the correction of, erroneous Form U-5 information.<sup>25</sup> The Form U-5 is completed by the former employer with no input by the terminated employee.<sup>26</sup> Short of initiating an arbitration proceeding,<sup>27</sup> a terminated employee who disputes the accuracy of Form U-5 information has no means of compelling his former employer to correct inaccurate Form U-5 information,<sup>28</sup> although there are less formal means by which some terminated representatives can have a rebuttal included in the CRD.<sup>29</sup>

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25. See *infra* note 29 and accompanying text.

26. Individuals authorize former employers to provide Form U-5 information. The Form U-4 — which individuals are required to complete when they enter or change employment in the securities industry or when certain reportable events occur — authorizes former employers to provide information regarding, among other things, the individual's credit-worthiness, character, ability, business activities, educational background, general reputation, employment history, and reasons for termination. The Form U-4 also contains a provision whereby the individual releases former employers from liability for furnishing such information on the Form U-5. The Form U-4 waiver language does not appear to have been intended to immunize prospectively defamatory Form U-5 statements made in bad faith. See *infra* note 58 and accompanying text.

27. SRO rules generally require that employment-related disputes between broker-dealers and their registered representatives be arbitrated, and registered representatives agree to be bound by such rules when they execute a Form U-4. Although claims of Form U-5 defamation arise after the termination of employment, they are arbitrable due to the nexus between the employment relationship and the alleged post-employment defamation. See, e.g., *Fleck v. E.F. Hutton Group, Inc.*, 891 F.2d 1047, 1050-53 (2d Cir. 1989).

28. See Leahy, *supra* note 5, at 25.

29. Former employees who remain in the securities industry may submit a written response when they execute a Form U-4 in connection with their application to associate with a new broker-dealer. Such a response is included in the CRD. Nevertheless, the disputed information from the Form U-5 remains in the CRD and continues to be available to all who have access to CRD information. However, representatives who are unable to find employment within the securities industry (whether or not this inability stems from the inaccurate Form U-5) or individuals who elect to leave the industry do not have occasion to execute a new Form U-4. Consequently, such individuals have no means of including in the CRD their version of disputed events.

The CRD system is currently undergoing a major redesign. Implementation of the revised system is scheduled to begin in 1996. As part of the CRD redesign, Forms U-4 and U-5 have been substantially revised, and the forms will be filed electronically. The most significant changes relate to the disclosure questions on Forms U-4 and U-5 (i.e., Question 22 on the Form U-4 and Questions 13 through 15 on the Form U-5), which will be made more parallel and will require more detailed reporting. The planned changes also will provide individuals with greater opportunities to respond to negative information reported about them on a Form U-5. Even with the planned changes, however, initiating an arbitration proceeding will remain the sole means by which an individual can compel a former employer to correct a Form U-5 that contains false information.

The Form U-5's potential as a source of defamation claims is obvious. The form requires the reporting of information that is directly relevant to an individual's business reputation and conduct, including suspicions of misconduct that may ultimately prove unfounded. Individuals who dispute the accuracy of a Form U-5 have limited opportunity to require that the form be corrected. Moreover, due to the time necessary to arbitrate a Form U-5 dispute, any such correction is unlikely to be compelled before the false information has been republished. Information reported on the form is widely available, not only to regulators, but also to individuals' prospective employers. Indeed, broker-dealers that are NASD members are obligated to consider the Form U-5 information in making hiring decisions. And, even when the presence of negative information does not prevent an individual from gaining subsequent employment within the securities industry, the processes of changing employers is substantially slowed when a Form U-5 contains negative information. Thus, it is hardly surprising that disputes over the accuracy of Forms U-5 have increasingly led to litigation in recent years. The following section reviews this trend and the relatively small number of disputes that have moved from the various arbitration forums into the courts.

### *III. Defamation Cases Involving Forms U-5*

#### *A. Arbitration Claims*

Perhaps the most overlooked aspect of the current discussion of Form U-5 defamation is the relative infrequency with which disputes over the content of forms have actually ripened into litigation through the filing of arbitration claims. Although it is clear that arbitration panels have from time to time directed broker-dealers to pay substantial sums for Form U-5 defamation, such awards are not the norm and have not been directed when the facts reflected that broker-dealers either truthfully reported negative information or inadvertently reported inaccurate information. Rather, most large awards appear to have been directed in cases in which the evidence suggested deliberate reporting of inaccurate information or other forms of abusive behavior in connection with Form U-5 reporting.<sup>30</sup> Overall, it is far

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30. See, e.g., *Ulrich v Whitaker*, NASD Arbitration No. 93-281 (Jan. 11, 1995) (\$1,875,000 award attributable in part to firm's false reporting of adverse information on Form U-5 to gain concessions from former employee in negotiations over severance package); *Benzer v Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1992-2500 (Apr. 4, 1994) (\$65,000 in actual damages and \$65,000 in punitive damages awarded based on finding that broker-dealer was "grossly negligent in its failure to verify the accuracy" of information

more common for arbitrators either to dismiss Form U-5 defamation claims or to direct that the form be amended without awarding any monetary damages. The available statistics do not suggest that such claims are routinely raised or that large damage awards are the norm in such claims.

The overall number of securities-related arbitrations has increased significantly in recent years. Case filings currently average approximately 6,600 per year. The American Arbitration Association handles approximately ten percent of the claims, and SROs handle the balance. The NASD handles approximately eighty percent of the SRO cases.<sup>31</sup> The "industry" disputes that may include claims of Form U-5 defamation represent approximately two percent of the claims that are actually arbitrated by the NASD.<sup>32</sup> A review of awards issued by all SROs in such cases since 1989, when arbitration awards became publicly available, yielded only fifty-five litigated cases that in some manner involved claims of Form U-5 defamation. Thus, arbitration claims that related to Form U-5 defamation represent not only a tiny percentage of the total universe of SRO arbitration awards, but also a small fraction of those issued in "industry" disputes.

Only seven of the fifty-five cases can be characterized as "pure" defamation claims. In two of these "pure" defamation cases, the defamation claims were sustained and the broker-dealers were directed to file amended

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in Form U-5); *Naparst v Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1993-3433 (Mar. 28, 1994) (\$175,000 in damages awarded because stated reason on Form U-5 for termination was defamatory and without merit, and former employer was required to file amended Form U-5 stating that individual had been terminated because he was believed to have accepted a position with a competing broker-dealer); *Baravati v Rosenkantz Lyon & Ross Inc. n/k/a Josephthal Lyon & Ross Inc.*, NASD Arbitration No. 91-419 (Jan. 12, 1993) (punitive damages awarded because of "unconscionable language" contained in Form U-5 that had caused "severe harm"); *Watkins v Edward D. Jones & Co.*, NASD Arbitration No. 88-1248 (June 14, 1989) (\$248,163.80 in damages awarded and broker-dealer was directed to file amended Form U-5 acknowledging that previously reported allegations of wrongdoing and unsupervisability were unsupported, and firm would be required to pay additional \$500,000 if corrected Form U-5 was not filed within 30 days). *See also* *Fahnestock & Co. v Waltman*, 935 F.2d 512, 516 (2d Cir. 1991), *cert. denied*, 502 U.S. 1120 (1992) (affirming award of \$100,000 in actual damages for defamation and \$100,000 in punitive damages based on "ample" record evidence of broker-dealer's "flagrantly spiteful conduct, demonstrating its intent simply to injure [former employee's] reputation").

31. *See, e.g.*, Martin L. Budd, *Securities Industry Arbitration — Recent Issues* (Dec. 9, 1994), reprinted in *BROKER-DEALER REGULATION: ALI-ABA COURSE OF STUDY MATERIALS* 205, 207 (1995).

32. In 1993, 5,419 cases were filed with the NASD. Of these, 2,723 were resolved without arbitration, and 1,604 went to arbitration. Of the cases that were arbitrated, only 275 involved disputes between members of the securities industry. The balance were brought by customers against brokerage firms. *Id.*

Forms U-5, but no monetary damages were awarded.<sup>33</sup> In the remaining five cases, substantial damages were awarded, although correction of the defamatory Form U-5 was not ordered in all cases.<sup>34</sup>

More typical than the "pure" defamation claims are cases in which defamation claims were raised in connection with other charges, such as wrongful termination. In eleven of these "mixed" cases, the defamation claims were dismissed, although in two cases the dismissal was coupled with a requirement that an amended Form U-5 be filed.<sup>35</sup> Monetary awards in the remaining "mixed" cases follow no consistent pattern. The awards in such cases typically direct the payment of damages without any identification of the portions of the award that are attributable to specific claims.<sup>36</sup> There-

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33. See *Nobil v. Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1992-2549 (Jan. 28, 1994); *Smukler v. Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1992-2240 (July 14, 1993).

34. See *Ulrich v Whitaker*, NASD Arbitration No. 93-281 (Jan. 11, 1995) (\$625,000 in actual damages and \$1,250,000 in punitive damages; no correction ordered); *Benzer v Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1992-2500 (Apr. 4, 1994) (\$65,000 in compensatory damages and \$65,000 in punitive damages; finding no defamation; no correction ordered); *Zackoff v Masterson Moreland Sauer Whisman, Inc.*, NASD Arbitration No. 92-913 (Nov 9, 1993) (\$30,000 in actual damages, costs of \$56,000, and attorney fees of \$50,000; correction ordered); *Polk v Merrill Lynch, Pierce, Fenner & Smith Inc.*, NASD No. 91-1450 (Mar. 27, 1992) (\$200,000 in actual damages, apparently for Form U-5 defamation; correction ordered); *Watkins v Edward D. Jones & Co.*, NASD Arbitration No. 88-1248 (June 14, 1989) (\$248,163.80 in damages; correction ordered; firm directed to pay additional \$500,000 in damages if corrected Form U-5 was not filed within 30 days).

35. See *Pepe v Emanuel & Co.*, NASD Arbitration No. 93-0516 (May 10, 1995) (defamation claim dismissed as untimely); *Joyce v Legg Mason Wood Walker, Inc.*, NASD Arbitration No. 93-5039 (Mar. 8, 1995) (all claims dismissed); *Sheeley v G.N.A. Sec. Co.*, NASD Arbitration No. 93-4971 (Feb. 28, 1995) (all claims dismissed, but correction ordered); *Lowry v Expansion Capital Sec.*, NASD Arbitration No. 93-4256 (Dec. 29, 1994) (Form U-5 defamation claim dismissed); *Dranove v Kidder, Peabody & Co.*, NASD Arbitration No. 93-1546 (July 29, 1994) (all claims dismissed); *Clem v Prudential Sec., Inc.*, NASD Arbitration No. 92-4083 (Feb. 18, 1994) (defamation claim dismissed, but correction ordered); *Denes v PaineWebber, Inc.*, NASD Arbitration No. 92-3563 (Jan. 19, 1994) (defamation claim dismissed); *Albanese v Gruntal & Co.*, NYSE Arbitration No. 1993-3116 (Oct. 13, 1993) (all claims dismissed); *Scippio v TMI Equities, Inc.*, NASD Arbitration No. 92-2766 (July 15, 1993) (same); *DeWindt v Shearson Lehman Hutton, Inc.*, NYSE Arbitration (July 22, 1991) (same); *McKie v American Interstate Fin. Corp.*, NASD Arbitration No. 91-2515 (Apr. 22, 1992) (defamation claim dismissed).

36. See *Schupbach v Prudential Sec., Inc.*, NASD Arbitration No. 93-1754 (June 23, 1995) (\$299 awarded on claims that included Form U-5 defamation); *Kashkin v Robert Todd Fin. Corp.*, NASD Arbitration No. 93-4778 (June 13, 1995) (\$8,556.28 in damages; correction ordered); *Honn v R.J. Steichen and Co.*, NASD Arbitration No. 93-2443 (Sept. 2, 1994) (\$7,312.50 awarded as compensatory damages, penalties, and attorneys fees; correction ordered); *Naparst v Shearson Lehman Bros., Inc.*, NYSE Arbitration No. 1993-3433

fore, in most "mixed" cases it is difficult to determine how much of an award of monetary damages, if any, can be attributed to Form U-5 defamation. In some "mixed" cases, the claim of Form U-5 defamation was raised as a counterclaim after an individual's former employer initiated an arbitration proceeding against the individual. As with the other "mixed" cases, there is no pattern to the disposition of defamation claims raised as counterclaims.<sup>37</sup> Finally, it appears that in three cases arbitrators *sua sponte*

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(Mar. 28, 1994) (\$175,000 in compensatory damages; correction ordered); Lockwood v Donald & Co. Sec., NASD Arbitration No. 92-2213 (Mar. 9, 1994) (\$25,000 in damages for Form U-5 defamation; correction ordered); Richard v Merrill Lynch, Pierce, Fenner & Smith, Inc., NASD Arbitration No. 93-552 (Feb. 28, 1994) (\$8,832.58 in damages; correction ordered); Glennon v. Dean Witter Reynolds, Inc., NASD Arbitration No. 91-2594 (Oct. 7, 1993) (\$728,250 in compensatory damages and \$750,000 in punitive damages for Form U-5 defamation; \$213,878 in attorney fees; correction ordered); Baravati v Rosenkrantz Lyon & Ross, Inc. n/k/a Josephthal Lyon & Ross Inc., NASD Arbitration No. 91-419 (Jan. 12, 1993) (\$60,000 in actual damages; \$120,000 in punitive damages; correction ordered); Bulfin v Dean Witter Reynolds, Inc., NYSE Arbitration No. 1990-1372 (May 12, 1992) (\$61,950 in damages; correction ordered); Berkeley v PaineWebber, Inc., NASD Arbitration No. 90-2908 (Feb. 27, 1993) (\$1 million in actual damages; correction ordered); Wiener v Shearson Lehman Bros., Inc., 1991 WL 330320 (NYSE Arbitration, Oct. 18, 1991) (\$135,000 in damages for wrongful termination; defamation claim dismissed); Wong v Smith Barney, Harris Upham & Co., NYSE Arbitration No. 1991-284 (Aug. 29, 1991) (\$45,000 in damages; correction ordered); Leighton v Morgan Keegan & Co., NYSE Arbitration (Apr. 9, 1991) (correction ordered); Urban v Prudential-Bache Sec., Inc., NASD Arbitration No. 89-242 (Mar. 4, 1991) (\$10,000 in damages); Wilson v Prudential-Bache Sec., Inc., NASD Arbitration No. 89-2328 (Nov. 12, 1990) (correction ordered); Emrick v Deutsch Bank Capital Corp., NYSE Arbitration (Nov. 11, 1990) (\$65,416 in damages; no correction ordered); Keitel v PaineWebber, Inc., NASD Arbitration No. 89-2393 (Oct. 4, 1990) (\$22,349 in damages; correction ordered); Prescott, Ball & Turben, Inc. v Kanuth, NASD Arbitration No. 88-1919 (May 2, 1990) (total damage award of \$38,232,979, including \$1 million for defamation and punitive damages of \$1 million; correction ordered); Russo v. Bateman Eichler, Hill Richards, Inc., NASD Arbitration No. 87-847 (Dec. 8, 1989) (\$3,500 in damages; correction ordered; firm directed to pay additional \$75,000 if corrected Form U-5 not filed within 30 days); Moran v Merrill Lynch, Pierce, Fenner & Smith, Inc., NYSE Arbitration (Oct. 26, 1989) (\$30,500 in damages; correction ordered; broker-dealer directed to send copy of corrected Form U-5 to state employment commission). *But see* Deutsch v. Raymond James & Assocs., NASD Arbitration No. 91-1238 (Feb. 28, 1992) (attributing amounts to specific claims: \$1.00 in compensatory damages and \$50,000 in punitive damages for Form U-5 defamation claim; \$22,013 awarded for other claims; correction of Form U-5 required).

<sup>37</sup> See *Glenfed Brokerage Servs. v PaineWebber, Inc.*, NASD Arbitration No. 94-5065 (June 13, 1995) (defamation counterclaim dismissed; correction ordered); *PaineWebber, Inc. v Miceli*, NASD Arbitration No. 94-1058 (Mar. 29, 1995) (\$47,706.76 awarded on defamation and other counterclaims; no correction ordered); *PaineWebber, Inc. v Batu*, NASD Arbitration No. 92-4233 (Dec. 12, 1994) (\$10,000 awarded for defamation); *Johnston Lemon & Co. v. Smith*, NASD Arbitration No. 92-218 (July 8, 1994) (two former employees

directed that Forms U-5 be corrected, although the arbitration claimants did not raise a defamation claim or request correction.<sup>38</sup>

Broker-dealers' expressions of extreme concern over defamation exposure from supplying adverse information on the Form U-5 thus appear disproportionate to the actual extent of such exposure, particularly when truth constitutes a complete defense to defamation claims. Perhaps, as is the case in another area of substantial concern to broker-dealers — the award of punitive damages in arbitration — the perception that a substantial threat exists, rather than the reality of such a threat, forms the basis for arguments that a drastic overhaul of existing law is needed.<sup>39</sup>

### B. Judicial Decisions

To date, only five courts have ruled on defamation claims that arose in the context of U-5 information.<sup>40</sup> Four are federal court decisions (two from

awarded \$175,000 and \$100,000, respectively, for broker-dealer's "improper conduct"; broker-dealer directed to file corrected Forms U-5); *PaineWebber, Inc. v Flickinger*, NASD Arbitration No. 92-4145 (Mar. 21, 1994) (defamation counterclaim dismissed; correction ordered); *PaineWebber, Inc. v Grimal*, NASD Arbitration No. 91-1713 (Mar. 16, 1992) (correction ordered); *Smith Barney, Harris Upham & Co. v Sullivan*, 1991 WL 330337 (NYSE Arbitration, Oct. 10, 1991) (defamation counterclaim dismissed); *PaineWebber, Inc. v Bahary*, NASD Arbitration No. 90-2913 (Sept. 30, 1991) (correction ordered); *Prudential-Bache Sec., Inc. v. Berman*, NYSE Arbitration (May 18, 1991) (counterclaims dismissed); *Rauscher Pierce Refsnes, Inc. v Stallones*, NASD Arbitration No. 87-2231 (Dec. 12, 1990) (correction required; damages for claim and counterclaim offset); *Bear Stearns & Co. v Browne*, 1990 WL 306705 (NYSE Arbitration, June 23, 1990) (\$1.00 awarded on both claim and counterclaim); *Shearson Lehman Hutton, Inc. v Jablonski*, 1990 WL 306333 (NYSE Arbitration, Mar. 2, 1990) (correction required although defamation claim dismissed); *Fahnestock & Co. v. Waltman*, 1990 WL 306636 (NYSE Arbitration, Jan. 19, 1990) (\$100,000 awarded on defamation counterclaim; \$56,000 apparently awarded on wrongful termination counterclaim; \$100,000 in punitive damages).

38. See *Shearson Lehman Hutton, Inc. v. Gregoire*, NYSE Arbitration (Aug. 1, 1991); *Moss v. Prudential-Bache Sec., Inc.*, NYSE Arbitration (Feb. 28, 1991); *Rosenberg v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, NYSE Arbitration (Dec. 14, 1990).

39. See generally Dwight Golann, *Consumer Litigation in the Age of Combat Bankang*, 45 BUS. LAW 1761, 1771 & nn. 57-59 (1990) (stating that contrary to perception, punitive damage verdicts are not routinely awarded and, when awarded, are usually not astronomical); Stephen Daniels & Joanne Martin, *Myth and Reality in Punitive Damages*, 75 Minn. L. Rev 1 (1990) (same); Joan Biskupic, *The Case of the \$4 Million BMW: Award to Owner of Repainted Car Is At Heart of Punitive Damages Debate*, WASH. POST, May 29, 1995, at A4 (large punitive damage awards that receive wide publicity, such as those awarded for undisclosed repainting of automobile or burns caused by scalding coffee served at drive-through restaurant, have disproportionate effect on public perceptions although awarded in small percentage of cases and, when challenged, are often reduced).

40. This figure excludes cases in which Form U-5 defamation issues were raised in some manner, but the courts did not rule on privilege issues. This category includes *Twiss v. Kury*,

courts of appeals, and two from district courts) and one is a decision from the intermediate state court in New York. Three of the five cases arose in the context of actions to confirm or set aside arbitration awards,<sup>41</sup> and consequently, the role of the reviewing courts was extremely circumscribed.<sup>42</sup> In each of these cases, the courts concluded that broker-dealers enjoy only a qualified privilege for defamatory information reported on Forms U-5. In

25 F.3d 1551 (11th Cir. 1994) (holding that under Florida law, investors may bring negligence action against broker-dealer that failed to report misconduct on terminated individual's Form U-5); *Fleck v. E.F. Hutton Group, Inc.*, 891 F.2d 1047 (2d Cir. 1989) (holding that Form U-5 defamation claims are arbitrable); *Haburjak v. Prudential-Bache Sec., Inc.*, 759 F. Supp. 293 (W.D.N.C. 1991) (granting broker-dealer's motion for summary judgment on claim that firm failed to timely file Form U-5 for terminated employee); *Safford v. PaineWebber, Inc.*, 730 F. Supp. 15 (E.D. La. 1990) (dismissing claims of Form U-5 defamation as untimely); *Merrill Lynch Futures, Inc. v. Miller*, 686 F. Supp. 1033 (S.D.N.Y. 1988) (noting firm's proffered defense, in defamation action alleging oral defamation by terminating employer to subsequent employer, that Form U-5 attributed individual's discharge to his failure to disclose trading improprieties); *Feinberg v. Oppenheimer & Co.*, 658 F. Supp. 892 (S.D.N.Y. 1987) (holding that defamation claims based on Form U-5 statements are arbitrable).

41. As previously noted, *supra* note 27, SRO rules effectively require arbitration of disputes over Form U-5 reporting.

42. The standard of review that courts must apply to motions to vacate arbitration awards is extremely deferential. As a general matter, arbitration awards may not be set aside unless they evidence manifest disregard of the law. *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953), *overruled on other grounds by Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484-85 (1989). To constitute "manifest disregard of the law," an error must have been "obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986). Further, the term "disregard"

implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it. The governing law alleged to have been ignored by the arbitrators must be well defined, explicit, and clearly applicable. [Courts] are not at liberty to set aside an arbitration panel's award because of an arguable difference regarding the meaning or applicability of laws urged upon [them].

*Id.* at 933-34 (citations omitted).

Moreover, arbitrators are not required to explain their awards. *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960). Thus, an arbitration panel's failure to explain how it determined damage awards for Form U-5 defamation does not constitute manifest disregard of the law. *See id.* at 597-98 (enforcing arbitrator's ambiguous opinion that permitted inference that arbitrator may have exceeded authority or that arbitrator premised award on construction of agreement).

Given the very deferential standard that courts must apply in reviewing arbitration awards and the absence of any requirement that arbitrators explain their reasoning for defamation rulings, most of the Form U-5 defamation decisions discussed in the text are not necessarily indicative of what the same courts would do if confronted with the same issues in the first instance.



two of the five cases, however, courts reached the opposite conclusion, and ruled that broker-dealers are absolutely protected when they report defamatory information on Forms U-5. Interestingly, both of these cases were litigated in court in the first instance, instead of reaching court in the more common context of a motion to confirm or set aside an arbitration award.

1. *The Qualified Privilege Cases:*

Baravati v Josephthal, Lyon & Ross; Fahnstock & Co. v Waltman;  
and Glennon v Dean Witter Reynolds, Inc.

The following subsection reviews the three decisions that have rejected arguments that Form U-5 information should enjoy complete protection from defamation liability. Although the decisions reached the common conclusion that only a qualified privilege protects Form U-5 information, they applied somewhat differing analyses. One court analogized Form U-5 information to employee references, which have enjoyed a qualified privilege under the common law. The other two courts drew an analogy between Form U-5 information and statements made pursuant to a legal duty, which also have enjoyed qualified protection under the common law.

a. *Employee References*

The most recent federal appellate decision in the area is *Baravati v Josephthal, Lyon & Ross, Inc.*<sup>43</sup> As is typical in Form U-5 defamation cases, *Baravati* arose from a less-than-amicable termination of an individual's employment. Ahmad Baravati obtained from his clients indications of interest in an initial public offering that some of the clients subsequently withdrew.<sup>44</sup> A disagreement developed between Baravati and his supervisors over the handling of these cancellations, and eventually Baravati called the local office of the SEC to relay his concerns over the matter.<sup>45</sup> This call prompted an SEC inquiry, which in turn appears to have precipitated Baravati's involuntary termination.<sup>46</sup> After Josephthal fired Baravati, the firm filed a Form U-5 which indicated that, at the time of his termination,

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43. 28 F.3d 704 (7th Cir. 1994).

44. *Baravati v Josephthal, Lyon & Ross, Inc.*, 834 F Supp. 1023, 1025 (N.D. Ill. 1993), *aff'd*, 28 F.3d 704 (7th Cir. 1994).

45. 834 F Supp. at 1025-26.

46. Firm records reflected that, approximately one week before Baravati's termination, his immediate supervisor had requested that he be terminated for failing to follow company policy. However, it was not until later in the day on which the SEC interviewed the supervisor that Baravati was terminated. *Id.* at 1026.

Baravati was under internal review for "wrongful taking of firm property" in the amount of \$7,650.<sup>47</sup>

Baravati filed an arbitration claim in which he sought damages for, among other things, retaliatory discharge and defamation.<sup>48</sup> An NASD arbitration panel directed that the firm and various of its officials pay Baravati \$60,000 in actual damages on his various claims, plus \$120,000 in punitive damages for what the panel characterized as the "unconscionable language" contained in Baravati's Form U-5. The panel stated that this language had caused Baravati "severe harm."<sup>49</sup> The panel also directed that the firm file an amended Form U-5 that deleted the offending language.<sup>50</sup>

When Baravati asked a federal court to confirm the award, Josephthal resisted on the ground that statements in the Form U-5 were absolutely privileged, based on an absolute privilege recognized under common law for statements made in connection with quasi-judicial proceedings.<sup>51</sup> The district court rejected this argument and confirmed the award.<sup>52</sup>

The firm appealed to the United States Court of Appeals for the Seventh Circuit, and the Court of Appeals affirmed. Significantly, the privilege issue raised in *Baravati* was a narrow one: whether information reported on the Form U-5 enjoyed an absolute privilege. All parties conceded that Form U-5 information enjoyed the same qualified privilege that employee references are traditionally accorded.<sup>53</sup> As is the case with any qualified privilege, the limited protection traditionally afforded to employee references can be forfeited if abused.<sup>54</sup> Given the lack of any apparent dispute that Josephthal knew the information reported on Baravati's Form U-5 was false, the case turned on whether the information was protected by an absolute privilege.

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47. *Id.* In addition, the firm sent a letter to state labor officials which indicated that Baravati had been terminated for cause and owed the firm approximately \$4,900 for unauthorized trades. *Id.* The Form U-5 prompted the NASD to review the circumstances surrounding Baravati's termination. The investigation was concluded without initiation of a disciplinary action. *See id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 1027-28.

52. *Id.* at 1028-29, 1038.

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

54. The *Baravati* court noted that, under Illinois law, the employee-reference privilege can be lost if an employer knows or is reckless in failing to discover that it is defaming an employee falsely. *Id.*

The Seventh Circuit began its analysis by noting that the NASD was invested with quasi-judicial responsibilities under the federal securities laws and that participants in the proceedings through which the NASD discharged those responsibilities enjoyed an absolute privilege to the same extent as in judicial proceedings.<sup>55</sup> The court, however, noted that the submission of a Form U-5 and its transmission to NASD member firms did not represent stages in the NASD's quasi-judicial disciplinary process. Instead, the court viewed the form as the means by which the NASD administered an "employment clearinghouse" through which NASD member firms obtained potentially valuable information concerning the availability and suitability of potential employees.<sup>56</sup> The court reasoned that this information-sharing service was remote from a judicial proceeding, notwithstanding that Form U-5 information — like any item of information — could trigger an NASD investigation or be introduced as evidence in a disciplinary proceeding. Consequently, the court concluded that insulating broker-dealers from all liability for the contents of Forms U-5 "would be tantamount to allowing a member of the NASD to blackball a former employee from employment throughout [a] large sector of the [securities] industry "<sup>57</sup>

*Baravati* is the only judicial decision that addresses an argument that is apparently raised with some frequency in arbitration proceedings: that individuals who enter the securities industry waive their rights to bring defamation claims against broker-dealer employers by executing the Form U-4. The Form U-4 contains language that authorizes broker-dealers to submit Form U-5 information and releases the broker-dealer from at least some defamation liability for Form U-5 reporting.<sup>58</sup> Based on this waiver

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55. *Id.*

56. *Id.*

57. *Id.*

58. The Form U-4 includes a provision whereby the registered representative authorizes:

[A]ll my employers and any other person to furnish to any jurisdiction or organization or any agent acting on its behalf, any information they have, including my creditworthiness, character, ability, business activities, educational background, general reputation, history of my employment and, in the case of former employers, complete reasons for my termination. Moreover, I release each employer, former employer and each other person from any and all liability, of whatever nature, by reason of furnishing any of the above information, including that information reported in the [Form U-5].

Before November 1991, the Form U-4 did not contain the language in the second sentence quoted above, which releases employers and former employers from liability with respect to information included in Forms U-5. The pre-1991 version of the form contained less specific

language, broker-dealers frequently defend defamation claims in arbitration on the ground that the Form U-4 waiver language confers an absolute privilege on defamatory Form U-5 statements. However, arbitration decisions indicate that while the waiver argument is regularly raised, arbitration panels routinely reject it, albeit implicitly<sup>59</sup>

The *Baravati* court directly addressed the waiver argument and summarily dismissed it as frivolous.<sup>60</sup> Further, the *Baravati* court went so far as to suggest that if it were the practice of arbitrators to refuse to recognize an absolute privilege for Form U-5 defamation, broker-dealers' consent to have Form U-5 defamation claims adjudicated in arbitration could constitute a waiver of any absolute privilege that might otherwise exist.<sup>61</sup>

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waiver language regarding statements by former employers.

Filings connected with the SEC's approval of the 1991 version of the Form U-4 indicated that the revision to the waiver language was made in recognition of 1989 changes to the NASD's rules, under which Forms U-5 were for the first time required to be provided to terminated individuals and their prospective employers. See generally Notice of Proposed Rule Change by NASD, Inc. Relating to Amendment to Form U-4 and to Form U-5, Exchange Act Release No. 27,683, 1990 WL 309911 (Feb. 7, 1990) (explaining purpose of proposed change). Nothing in the rule filings that accompanied the 1991 changes to the Form U-4 indicated an intent to immunize broker-dealers from all defamation liability. The absence of any discussion of privilege issues in the 1991 rule filings and the SEC's adopting release suggests no intent that the revised Form U-4 language prospectively immunize providers of Form U-5 information from all defamation liability.

59. See, e.g., *Zackoff v Masterson Moreland Sauer Whisman Inc.*, NASD Arbitration No. 92-913 (Nov 9, 1993). Given the extremely deferential standard of review that courts must apply when reviewing arbitration awards, see *supra* note 42, an arbitration panel's failure explicitly to address this waiver argument does not constitute a basis for setting the panel's award aside.

60. *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 706 (7th Cir. 1994). The same waiver argument was raised in *Fahnestock & Co. v Waltman*, 935 F.2d 512 (2d Cir. 1991), discussed *infra* notes 62-74 and accompanying text, and in *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994), discussed *infra* notes 75-87 and accompanying text, but was not addressed in the courts' decisions. See Brief of Petitioner-Appellant, Cross-Appellee *Fahnestock & Co.* at 11 n.\*, *Fahnestock & Co. v Waltman*, 935 F.2d 512 (2d Cir. 1991) (No. 90-7867, 90-7869); Brief of the Securities Industry Association, Inc. as *Amicus Curiae* in Support of Petitioner-Appellant/Cross-Appellee at 13-15, *Fahnestock & Co. v Waltman*, 935 F.2d 512 (2d Cir. 1991) (No. 90-7867, 90-7869); Dean Witter Reynolds, Inc.'s Memorandum of Law in Support of Motion to Vacate Arbitration Award in Whole or in Part at 29 n.12, *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994); Dean Witter Reynolds, Inc.'s Reply Memorandum of Law in Support of Motion to Vacate Arbitration Award in Whole or in Part and in Opposition to Plaintiff's Cross-Motion to Confirm Award at 16-17, *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994) [all briefs on file with the *Washington and Lee Law Review*].

61. *Baravati*, 28 F.3d at 708. The court noted that the record did not reflect whether

*b. Statements Made Pursuant to Legal Duty*

Two federal courts — one a court of appeals and the other a district court — have ruled that Form U-5 information is protected by a qualified privilege as statements made pursuant to a legal duty. The first of these is *Fahnestock & Co. v Waltman*,<sup>62</sup> whose facts are remarkably similar to those of *Baravati*. Fahnestock & Co. terminated Joseph Waltman because the firm was closing the division that Waltman headed. The firm filed an initial Form U-5 that attributed Waltman's departure to "business consolidation." Later, when a dispute arose over the ownership of certain files, Fahnestock amended Waltman's Form U-5 to indicate that he had been fired for cause and had stolen property from the firm. Fahnestock also brought an arbitration proceeding against Waltman seeking return of the disputed files and damages. Waltman filed a counterclaim in which he alleged that the firm and several of its officials had defamed him by filing the amended Form U-5.<sup>63</sup>

The NYSE arbitration panel heard testimony concerning threats by the chairman of Fahnestock's board to have Waltman arrested for failing to return the disputed files, as well as testimony regarding the chairman's instructions to file an amended Form U-5 to indicate that Waltman had been terminated for cause and had stolen firm property. The arbitrators also heard testimony that, in an effort to pressure Waltman into abandoning his defamation counterclaim, threats had been made to his subsequent employer.<sup>64</sup> The arbitrators awarded Waltman \$100,000 in actual damages and \$100,000 in punitive damages on his defamation claim.<sup>65</sup>

Waltman sought to have the award confirmed. Fahnestock sought to have the award vacated on the ground that the arbitrators had exceeded their authority in granting an award for defamation and in awarding punitive damages.<sup>66</sup> The district court denied the firm's petition to vacate the award

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it was the practice of arbitrators to refuse to recognize the existence of an absolute privilege. *Id.* A review of publicly available arbitration awards suggests that this may be the case. Indeed, only one award even acknowledged that the waiver argument had been raised, and it did not explicitly address the argument. See *Zackoff v Masterson Moreland Sauer Whisman, Inc.*, NASD Arbitration No. 92-913 (Nov. 9, 1993).

62. 935 F.2d 512 (2d Cir. 1991), *cert. denied*, 502 U.S. 1120 (1992). As noted *infra* note 75, however, *Glennon v Dean Witter Reynolds, Inc.* has been appealed to the United States Court of Appeals for the Sixth Circuit. It is expected that the case will be argued in late 1995.

63. *Id.* at 514.

64. *Id.*

65. *Id.* The arbitrators also awarded Waltman \$56,000 in compensatory damages for wrongful discharge and \$14,700 in legal fees. *Id.*

66. *Id.* at 515.

of compensatory damages, and rejected the firm's claim that statements made in the amended Form U-5 were absolutely privileged.<sup>67</sup> Instead, the district court found only a qualified privilege, which could be overcome upon a showing of malice or lack of probable cause for statements made in Forms U-5.<sup>68</sup>

On cross appeals, the United States Court of Appeals for the Second Circuit affirmed the award of compensatory damages for defamation. On the issue of immunity for statements made in Forms U-5, the court stressed that its standard of review was whether the arbitrators had manifestly disregarded the law in awarding the employee compensatory damages for defamation.<sup>69</sup>

The court noted the qualified privilege accorded under New York common law to statements made pursuant to a legal duty.<sup>70</sup> This privilege protects statements 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.<sup>71</sup> The court stressed, however, that such qualified privileges may be lost upon a showing that a communication was made with actual malice, which the court described as "personal spite or ill-will, or culpable recklessness or negligence."<sup>72</sup> Noting that there was ample record evidence of the firm's "flagrantly spiteful conduct, demonstrating its intent simply to injure Waltman's reputation," the court concluded that, although the firm was protected by a qualified privilege in filing the amended Form U-5, the arbitrators acted within their authority in determining that the qualified privilege did not protect the filing of the amended Form U-5.<sup>73</sup> As to Fahnestock's arguments that Form U-5 reporting was absolutely privileged, the court noted without elaboration that the arbitrators had apparently declined to extend the absolute privilege accorded to statements made in connection with judicial or quasi-judicial proceedings to Form U-5 statements.<sup>74</sup>

The second federal decision that has analyzed Form U-5 information in terms of the qualified privilege that protects statements made pursuant to a

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67 The district court, however, vacated the arbitrators' award of punitive damages, holding that arbitrators cannot award punitive damages. *Id.*

68. *Id.*

69. *Id.* at 516.

70. *Id.*

71. *Id.* (collecting New York cases on common-law privilege for statements made pursuant to legal duty).

72. *Id.*

73. *Id.*

74. *Id.*

legal duty is *Glennon v Dean Witter Reynolds, Inc.*,<sup>75</sup> which was decided by the United States District Court for the Middle District of Tennessee in 1994. The case involved John Glennon, an employee of Dean Witter Reynolds, Inc. Glennon's termination was precipitated in part by a dispute over money: The firm had paid Glennon approximately \$22,500 in excess expense allotments, which Glennon retained as an offset against approximately \$42,500 that he claimed the firm owed to him for recruitment and finder activities.<sup>76</sup> Following Glennon's termination, Dean Witter filed a Form U-5 which stated that, when terminated, Glennon had been under investigation for fraud and wrongful taking of property.<sup>77</sup> The Form U-5 further stated that Glennon had been terminated "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."<sup>78</sup>

Glennon brought an arbitration claim against Dean Witter in which, among other things, he sought damages for defamation.<sup>79</sup> Following a hearing, an NASD arbitration panel required Dean Witter to correct Glennon's Form U-5,<sup>80</sup> awarded Glennon \$728,250 in compensatory damages

75. No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994), *appeal docketed*, No. 95-5257 (6th Cir. 1995).

76. Although Glennon was entitled to an annual expense allotment of \$2,500, Dean Witter mistakenly paid him that sum monthly. He retained the excess payments as a setoff against the \$42,500 that he claimed the firm owed him. *See Glennon v Dean Witter Reynolds, Inc.*, NASD Arbitration No. 91-2594 at 3,4 (Oct. 7, 1993) [hereinafter *Glennon Award*].

77. *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994) at \*1. In fact, no such investigation was ongoing at the time, although there was an ongoing dispute as to Glennon's entitlement to certain compensation. *Id.*

78. *Id.*

79. Glennon had been the manager of Dean Witter's branch office in Nashville, Tennessee. His arbitration claim initially charged that the firm demoted him from his salaried managerial position to an unsalaried sales position after he reported to firm officials (or refused to condone) serious misconduct by branch office personnel. Glennon sought damages for retaliatory discharge, plus payment of approximately \$42,500 in finder's fees and recruitment bonuses. *See generally* Plaintiff's Memorandum of Law in Support of Cross-Motion to Confirm and in Opposition to Defendant's Motion to Vacate at 4-5, *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (W.D. Tenn. Dec. 15, 1994) (on file with the *Washington and Lee Law Review*); *Glennon Award*, *supra* note 76, at 2-4. Subsequently, Glennon amended his claim to include a defamation charge based on the explanation of his discharge contained in the Form U-5. *See generally* Plaintiff's Memorandum of Law in Support of Cross Motion to Confirm and in Opposition to Defendant's Motion to Vacate, at 4, *Glennon v Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (W.D. Tenn. Dec. 15, 1994) (on file with the *Washington and Lee Law Review*); *Glennon Award*, *supra* note 76, at 4.

80. *Glennon Award*, *supra* note 76, at 7. The award directed that Glennon's Form U-5

and \$750,000 in punitive damages on his defamation claim, and required the firm to pay Glennon attorney fees of \$213,000.<sup>81</sup>

Glennon brought an action to confirm the award, and Dean Witter sought to have it set aside. In challenging the award, Dean Witter maintained, among other things, that defamatory statements made on Forms U-5 were absolutely protected under the judicial or quasi-judicial privilege — the same common-law privilege addressed in *Baravati*.<sup>82</sup> The firm maintained that the same policies that caused the common law to accord an absolute privilege to statements made in connection with official or quasi-judicial proceedings — including the need to encourage cooperation and candor by parties called upon to provide information in connection with such proceedings — dictated that comparable protection should be accorded to defamatory information reported on Forms U-5.<sup>83</sup> Alternatively, the firm argued that the Form U-5 statements should enjoy the qualified privilege that Tennessee historically accorded to statements made in good faith pursuant to a legal duty.<sup>84</sup>

The district court sustained the arbitrators' award in all respects. As to Glennon's defamation claim, the court noted that Tennessee accords a qualified privilege to communications made in good faith upon any subject matter in which the communicating party has an interest or in reference to which he has a legal duty to a person having a corresponding interest or duty.<sup>85</sup> The court further noted that, although Dean Witter clearly had a duty to complete

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be amended to reflect that his termination had resulted from a dispute over compensation. *Id.* at 6.

81. The arbitrators also required Dean Witter to pay Glennon the approximately \$42,500 in finders fees and a recruitment bonus that he claimed the broker-dealer owed him and directed Glennon to refund the overpayments he had received from the firm. However, the arbitrators rejected Glennon's claim that he had been discharged in retaliation for his "whistle-blowing" activities. *Id.* at 6-7

82. See generally Dean Witter Reynolds' Memorandum of Law in Support of Motion to Vacate Arbitration Award in Whole or in Part and in Opposition to Plaintiff's Cross-Motion to Confirm Award at 25-30, Glennon v Dean Witter Reynolds, Inc., No. 3-93-0847, 1994 WL 757709 (W.D. Tenn. Dec. 15, 1994); Dean Witter Reynolds' Reply Memorandum of Law in Support of Motion to Vacate Arbitration Award in Whole or Part at 12, Glennon v Dean Witter Reynolds, Inc., No. 3-93-0847, 1994 WL 757709 (W.D. Tenn. Dec. 15, 1994) [briefs on file with the *Washington and Lee Law Review*].

83. Dean Witter Reynolds' Memorandum of Law in Support of Motion to Vacate Arbitration Award in Whole or in Part at 28-30, Glennon v Dean Witter Reynolds, Inc., No. 3-93-0847, 1994 WL 757709 (W.D. Tenn. Dec. 15, 1994) (on file with the *Washington and Lee Law Review*).

84. *Id.* at 30-31.

85. Glennon v Dean Witter Reynolds, Inc., No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994), at \*7



the Form U-5, it was unclear that the firm had completed the Form U-5 in good faith. Specifically, the court cited the record evidence regarding a history of ill will that had existed between Glennon and his superiors at Dean Witter.<sup>86</sup> Given this pattern of ill will, the court concluded that the arbitrators properly could have found that, under Tennessee law, the filing of Glennon's Form U-5 was not protected by *any* privilege.<sup>87</sup>

Curiously, the *Glennon* court reached this conclusion without any explicit discussion of Dean Witter's alternative argument: that Forms U-5 enjoy an absolute privilege. This omission is significant because, although bad faith will overcome qualified privileges, good faith and motive are completely irrelevant in the context of absolute privileges. Thus, if Forms U-5 are protected by an absolute privilege under Tennessee law, a history of ill will by Glennon's superiors would not cause the firm to forfeit this privilege.

## 2. *The Absolute Privilege Cases: Herzfeld & Stern v Beck and Culver v Merrill Lynch & Co.*

To date, two courts have held that Form U-5 information enjoys the same absolute privilege that protects statements made in connection with quasi-judicial proceedings. The holding in each case rested on constructions of New York law, although neither case devoted any discussion to *Fahnestock*, in which the Second Circuit also applied New York law but reached the opposite conclusion.

The first of these cases is *Herzfeld & Stern, Inc. v Beck*,<sup>88</sup> which was decided by New York's intermediate appellate court. The case is unusual in that it is one of only two Form U-5 defamation cases that did not arise in the context of an action to confirm or set aside an arbitration award.<sup>89</sup> It is also the only state court decision in the area.

86. *Id.* The court noted that the record included evidence that one of Glennon's supervisors had threatened Glennon, frightened him, and physically prevented him from leaving his office. *Id.*

87. *Id.*

88. 572 N.Y.S.2d 683 (N.Y. App. Div. 1991), *appeal dismissed*, 590 N.E.2d 251 (N.Y. 1992).

89. After the case had been pending in court several years, Herzfeld sought to compel Beck to arbitrate his defamation claim. The court declined to compel arbitration on the ground that Herzfeld's degree of involvement in judicial proceedings was such that belatedly requiring the matter to be arbitrated would prejudice Beck. *See* Settle Order of Judge Walter M. Schackman, *Herzfeld & Stern, Inc. v Beck*, No. 06261/86 (N.Y. Sup. Ct. Dec. 10, 1986).

After Warren Beck left the employ of Herzfeld & Stern, the broker-dealer filed a Form U-5 that indicated that Beck had terminated his employment voluntarily.<sup>90</sup> Subsequently, the firm amended the Form U-5 to reflect that it terminated Beck's employment as a result of unauthorized trading and noncompliance with the NYSE know-your-customer rule.<sup>91</sup> Upon receiving the amended form, the NYSE launched an investigation. In response to an NYSE inquiry, the firm wrote two defamatory letters to the exchange regarding Beck's conduct, and Beck sued for damages.<sup>92</sup>

The firm sought to dismiss the complaint based upon an absolute immunity for statements provided in Forms U-5, but the trial court denied the motion to dismiss. The *Herzfeld* court reversed the trial court's decision and dismissed the complaint on the ground that brokerage firms are required by law to provide information through the Form U-5 to the NYSE, a quasi-judicial body acting in its judicial capacity while investigating the matter. The court noted that the Form U-5, which the firm was compelled by law to file, had precipitated the exchange's investigation and that the two letters were sent to the exchange in connection with the investigation.<sup>93</sup> The court held that, under New York law, the absolute privilege for statements made in connection with quasi-judicial proceedings attached not only to the hearing stage, but to every step of the proceeding, including preliminary and investigatory stages, and regardless of whether formal charges were ever made. The court therefore held that both the amended Form U-5 and the two letters were prepared in connection with a quasi-judicial proceeding and were absolutely privileged under New York law.<sup>94</sup>

Significantly, *Herzfeld* focused on the role that the Form U-5 played in causing the NYSE to initiate an investigation. The court reasoned that once an investigation had been launched the absolute privilege that attached to quasi-judicial proceedings applied not only to information supplied in connection with the exchange's investigation, but also to the Form U-5 that prompted the investigation. The decision leaves unclear the status of defamatory Form U-5 information that does not lead to an SRO investigation;

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90. *Herzfeld & Stern, Inc. v Beck*, 572 N.Y.S.2d 683, 684 (N.Y. App. Div. 1991), *appeal dismissed*, 590 N.E.2d 251 (N.Y. 1992).

91. *Id.*

92. *Id.* The letters apparently discussed the charges contained in the amended Form U-5, but the *Herzfeld* court's decision does not describe their contents.

93. *Id.* at 685.

94. *Id.* The *Herzfeld* court did not cite to *Fahnestock & Co. v Waltman*, discussed *supra* notes 62-74 and accompanying text, which was decided two months earlier and which also applied New York law.

however, the court's analysis — under which the privileged status of the Form U-5 information derived from the resulting investigation — suggests that such information may not enjoy absolute immunity

Recently, in *Culver v Merrill Lynch & Co.*,<sup>95</sup> the United States District Court for the Southern District of New York followed *Herzfeld* and concluded that defamatory statements made in Forms U-5 enjoy absolute immunity under New York law. The case arose from Merrill Lynch's termination of James Culver. Following his termination, Culver filed a civil action in which he alleged, among other things, Form U-5 defamation, fraud, breach of contract, and violations of various whistle-blowing statutes,<sup>96</sup> and sought \$74 million in damages.<sup>97</sup> The Form U-5 that was filed following Culver's termination reported that he was terminated after Merrill Lynch learned that "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."<sup>98</sup> Culver, however, alleged that he was terminated in retaliation for reporting misconduct by the firm to appropriate authorities.<sup>99</sup>

Merrill Lynch moved to dismiss Culver's Form U-5 defamation claim on the ground that information reported in the form was absolutely privileged.<sup>100</sup> The court agreed, relying upon *Herzfeld*. The court reasoned that, as was the case in *Herzfeld*, the information that Merrill Lynch reported on the Form U-5 regarding Culver had been made "in the course of a quasi-judicial proceeding, and was 'material and pertinent' to the reasons for Culver's termination."<sup>101</sup> The court therefore held that, regardless of whether Merrill Lynch had acted with malice, the Form U-5 information about Culver was absolutely privileged. Thus, Culver's Form U-5 defamation claim was dismissed.<sup>102</sup>

*Culver* neither discussed nor attempted to distinguish decisions that have found the quasi-judicial proceedings privilege inapplicable to Form U-5

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95. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,811, at 92,885 (S.D.N.Y. July 17, 1995).

96. *Id.*

97. Lynnette Khalfani, *Judge's Ruling May Protect Wall Street From Defamation Suits by Ex-Brokers*, WALL ST. J., July 24, 1995, at A7A.

98. *Culver v Merrill Lynch & Co.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,881, at 92,886 (S.D.N.Y. July 17, 1995).

99. *Id.*

100. *Id.* at 92,888.

101. *Id.* at 92,888-89.

102. *Id.*

statements.<sup>103</sup> Because these decisions include *Fahnestock*, a decision of the Second Circuit construing New York law, the extent to which *Culver* may influence other courts remains to be seen. Nonetheless, *Culver* is an important decision because it is the first time that any federal court has found that defamatory Form U-5 information is absolutely privileged.

In addition to their common result, *Herzfeld* and *Culver* share the distinction of being the sole reported cases in which Form U-5 disputes were initially litigated in court rather than in an arbitration forum.<sup>104</sup> Consequently, it is tempting to attribute the conflict that exists between *Baravati*, *Fahnestock*, and *Glennon* on one hand; and *Herzfeld* and *Culver* on the other, to the deference that courts are required to apply when reviewing arbitration awards.<sup>105</sup> Because neither *Herzfeld* nor *Culver* attempted to distinguish contrary authorities on that (or any other) basis, however, the validity of such an explanation is uncertain. At present, all that can be said with certainty is that, based on an extremely small number of cases, it appears that claims of absolute privilege may fare better in courts applying New York law than in SRO arbitration forums.

#### IV Policies Favoring a Qualified Privilege

Whether broker-dealers should be granted an absolute as opposed to a qualified privilege for defamatory U-5 statements is a policy issue. Absolute privilege is conferred where society's interest in the free flow of a particular type of information is so strong that communicators are granted complete immunity from defamation liability.<sup>106</sup> Intent, good faith, and motive are irrelevant when an absolute privilege has been granted.<sup>107</sup> Qualified privileges, by contrast, are conferred when society's interest in encouraging the

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103. The *Culver* decision was issued on July 17, 1995, well after the four other decisions discussed in the text. As previously noted, *supra* note 94, the *Herzfeld* court did not cite to *Fahnestock*, which the Second Circuit had decided two months earlier.

104. As previously noted, *supra* note 27, most disputes over the content of Forms U-5 are required to be arbitrated. Consequently, the majority of Form U-5 disputes that have reached the courts have done so in the context of actions to enforce or to set aside arbitration awards.

105. As previously noted, *supra* note 42, courts reviewing arbitral decisions are required to apply the highly deferential "manifest disregard" standard. Thus, court decisions issued in this context are not necessarily indicative of what the same courts would do if confronted with the same issues in the first instance.

106. See generally PAUL ALEXANDER & VANESSA WELLS, EMPLOYEE, BUSINESS & PROFESSIONAL DEFAMATION § 7.04[1][a] (1992).

107 See, e.g., *id.*

flow of certain types of information is strong, but not sufficiently compelling to warrant protecting persons who defame out of highly improper motives or in a particularly egregious way. Unlike absolute privileges, qualified ones may be lost if abused.<sup>108</sup>

The courts that have addressed the Form U-5 immunity issue have reached differing conclusions on the relative importance to society of Form U-5 information. Based on the common-law privilege accorded to quasi-judicial proceedings, the *Herzfeld* and *Culver* courts apparently believed that society's interest in SRO disciplinary proceedings was sufficiently substantial to warrant recognition of an absolute privilege in at least some circumstances. On the other hand, the *Baravati* court reached the opposite conclusion on the applicability of this same common-law privilege to Form U-5 information. The *Fahnestock* and *Glennon* courts, by contrast, analyzed the provision of defamatory information on a Form U-5 under common-law qualified privileges recognized for information supplied pursuant to a legal or moral duty. The parties in *Baravati* conceded that the qualified privilege for employee references applied to Forms U-5. As with any qualified privilege, these privileges can be forfeited if the speaker acts with malice or through excessive publication.

Within the securities industry there is a widespread belief that statements made in Forms U-5 should be absolutely privileged because the grant of only a qualified privilege would have little effect on the volume of arbitration claims relating to Forms U-5. Some members of the industry maintain that a qualified privilege would be insufficient to allay their litigation-risk concerns and would not increase broker-dealer willingness to provide candid and complete information on the Form U-5. These members assert that only an absolute privilege would be sufficient to protect them.<sup>109</sup>

This argument appears to assume that broker-dealers face no litigation risk if they provide only "bare bones" information or file a "clean" Form U-5 when such an action is unwarranted by the facts. *Twiss v Kury*,<sup>110</sup> a

108. See generally RESTATEMENT (SECOND) OF TORTS §§ 593, 599-605A (1977); DAVID A. ELDER, DEFAMATION: A LAWYER'S GUIDE § 2.3[1], at 127-46 (1993); LAWRENCE H. ELDRIDGE, THE LAW OF DEFAMATION § 93, at 508-23 (1978); ALEXANDER & WELLS, *supra* note 106, § 7.04.[1][b], at 7-56, 7-57; Harold A. Jones, *Interest and Duty in Relation to Qualified Privilege*, 22 MICH. L. REV. 437 (1924); John E. Hallen, *Character of Belief Necessary for the Conditional Privilege in Defamation*, 25 ILL. L. REV. 865 (1931).

109. See, e.g., Brief of the Securities Industry Association as *Amicus Curiae* at 3, *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2d Cir. 1991) (No. 90-7867, 90-7869).

110. 25 F.3d 1551 (11th Cir. 1994); see also *Palmer v. Shearson Lehman Hutton, Inc.*, 622 So. 2d 1085 (Fla. Dist. Ct. App. 1993). The *Palmer* case was "based on identical facts [as in *Twiss*] (the only difference being the identity of the plaintiffs)." *Palmer*, 622 So. 2d

1994 decision of the United States Court of Appeals for the Eleventh Circuit, however, demonstrates that this assumption is invalid. *Twiss* involved David Kury, a registered representative who had been employed by E.F. Hutton until the firm discovered that he had engaged in misconduct and required him to resign. Following his termination, the firm filed a Form U-5 that did not reflect E.F. Hutton's awareness of Kury's misconduct. During the four years following his termination by E.F. Hutton, Kury remained in the securities industry until state officials ultimately revoked his securities license as a result of his involvement in a pyramid scheme.<sup>111</sup> Investors who became Kury's clients in the years after his departure from E.F. Hutton brought an action against Kury, E.F. Hutton, and others. The investors alleged, among other things, that E.F. Hutton had acted negligently with respect to Kury's current and future customers by misrepresenting the reasons for Kury's termination on the Form U-5.

The Eleventh Circuit held that the district court erred in part by granting the defendants' motion for summary judgment on the investors' negligence claim. The court upheld the district court's determination that E.F. Hutton owed no common-law duty to Kury's subsequent investors.<sup>112</sup> However, the court held that, under a state statute that made false reporting to state securities regulators unlawful, the investors' negligence action against E.F. Hutton should be allowed to go forward since E.F. Hutton was legally obligated to file Kury's Form U-5 with state securities officials.<sup>113</sup> Accordingly, the court remanded the investors' negligence action to the district court.<sup>114</sup> Thus, *Twiss* indicates that in some instances persons who entrust their investments to a problem representative following the filing of a "clean" Form U-5 can maintain negligence actions against the broker-dealer who failed to disclose the former employee's wrongdoing on the Form U-5.

Apart from such potential civil liability to injured investors, broker-dealers who fail to report misconduct accurately and completely on Forms U-5 may be subject to disciplinary actions by SROs.<sup>115</sup> Consequently, the

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at 1088.

111. *Twiss v. Kury*, 25 F.3d 1551, 1553 (11th Cir. 1994).

112. *Id.* at 1555.

113. *Id.* at 1555-56.

114. *Id.*

115. The NASD has stressed to NASD member firms their obligation to provide accurate and complete information on Forms U-5, and the NASD has warned that the failure to fulfill this obligation may lead to disciplinary action. See NASD NOTICE TO MEMBERS 88-67 (NASD, Inc. Washington, D.C.), Sept. 1988, at 73-74. To date, at least one arbitration panel has referred a case that involved a claim of Form U-5 defamation to the NASD for

option of censoring Form U-5 information in the hope of avoiding defamation litigation is not without litigation risks of its own.

Without minimizing the difficulties confronting broker-dealers, however, the debate over Form U-5 reporting often overlooks the fact that truth has long constituted a complete defense to defamation claims.<sup>116</sup> Therefore, truthful reporting of derogatory information on the Form U-5 should not give rise to defamation liability concerns. The real issue is the extent to which broker-dealers should be liable for reporting derogatory information that is untrue.

Regulators generally have supported according broker-dealers a qualified privilege for Form U-5 reporting that is defamatory and untrue. For example, the Chairman of the SEC has expressed support for adopting an SEC rule that would grant such immunity,<sup>117</sup> SEC staff have advocated adopting a qualified privilege through statute or through SEC rule,<sup>118</sup> and the NASD has expressed support for a federal statute that would protect Form U-5 reporting unless it was made either with knowledge that the information was false or in a grossly negligent or reckless manner.<sup>119</sup> A statutory or rule provision granting such a qualified privilege may be proposed within the next year.

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possible disciplinary action. *See* Glennon v Dean Witter Reynolds, Inc., NASD Disciplinary Referral No. 91-2594 (Oct. 5, 1993) (disciplinary referral to NASD concerning Dean Witter's actions regarding Glennon's Form U-5). The NASD's Code of Arbitration Procedure authorizes such disciplinary referrals when the record of an arbitration proceedings suggests that a violation of NASD rules or the federal securities laws has occurred. NASD Code of Arbitration Procedure, § 5, NASD Manual (CCH) ¶ 3705, at 3712 (1995). Other types of inadequate Form U-5 reporting have already formed the basis for SRO disciplinary action. *See In re* Edward D. Jones & Co., NYSE Hearing Panel Decision No. 94-166 (Dec. 19, 1994) (untimely filing); *In re* Dean Witter Reynolds, Inc., No. 85-19, 1985 WL 152219 (NYSE Hearing Panel Feb. 27, 1985) (same). *See also* Michael Siconolfi, *Regulators Press Firms to Identify Problem Brokers*, WALL ST. J., Sept. 29, 1995, at A3 (reviewing recent SRO disciplinary actions involving Form U-5 deficiencies).

116. *See generally* ELDER, *supra* note 108, § 2.2[B]; ELDRIDGE, *supra* note 108, §§ 63-71, at 323-38; KEETON ET. AL., PROSSER AND KEETON ON THE LAW OF TORTS § 116, at 839-42 (5th ed. 1984).

117. *See SEC Considering Qualified Immunity Rule Against Tort Suits By Former Employees*, 26 Sec. Reg. & L. Rep (BNA) No. 40, at 1372, 1372 (Oct. 14, 1994); *SEC Will Probe Smaller-Sized Firms, Levitt Tells House Rogue Broker Hearing*, 26 Sec. Reg. & L. Rep. (BNA) No. 36, at 1231, 1232 (Sept. 16, 1994).

118. LARGE FIRM REPORT, *supra* note 1, at 10.

119. *See* Letter from Joseph R. Hardiman, President, National Association of Securities Dealers, Inc., to Honorable Edward J. Markey, Chairman, House Subcommittee on Telecommunications and Finance 11 (Mar. 15, 1993) (on file with the *Washington and Lee Law Review*).

Whether such a qualified privilege proposal will be perceived as affording broker-dealers sufficient protection remains to be seen, however. Although some broker-dealers have supported recognition of a qualified privilege as a means of encouraging greater candor in Form U-5 reporting, others believe that a limited privilege will do little to deter the filing of arbitration claims alleging Form U-5 defamation. These members of the industry maintain that they will gain little if they are granted only a qualified privilege because they will continue to be named in arbitration claims and forced to incur the costs of defending nonmeritorious actions. Further, some broker-dealers maintain that the best means of encouraging accurate and complete reporting on the Form U-5 is not private damage actions for defamation, but SRO disciplinary actions against firms that fail to provide such reporting.

Clearly, increased SRO disciplinary actions against firms that fail to provide candid and complete Form U-5 reporting would underscore the importance of the form as a regulatory tool and deter incomplete or abusive reporting. However, it is less clear that damage awards for Form U-5 defamation do not also serve a deterrent function, particularly if awards are limited to cases in which inaccurate information is reported on the Form U-5 in bad faith, recklessly, or with knowledge of falsity. Thus, it is not self-evident why the SROs' ability to initiate disciplinary actions against firms that fail to fulfill their Form U-5 reporting obligations renders unnecessary private damage actions by persons who suffer reputational injury. This is particularly so given that large damage awards for Form U-5 defamation have been infrequent and rarely granted in frivolous or marginal cases. Indeed, the facts of such cases as *Baravati* and *Fahnestock* naturally raise questions about whether the grant of an absolute privilege would strike a fair balance between broker-dealers' litigation-risk concerns and registered representatives' reputational interests.

Further, to the extent that broker-dealers maintain that policy considerations dictate that they be given an absolute privilege for defamatory statements made in Forms U-5, they argue for a level of protection that even the SROs do not enjoy. Significantly, the two statutory provisions that address the SROs' potential liability for defamation in the reporting context grant only a qualified immunity. The first of these is Exchange Act Section 15A(i), which directed the NASD to establish a toll-free telephone service through which callers may obtain information on the disciplinary histories of securities firms and their registered personnel. Section 15A(i) provides



that the NASD "shall not have any liability to any person for any actions taken or omitted in good faith under this paragraph."<sup>120</sup>

Similarly, under the Securities Investor Protection Act of 1970,<sup>121</sup> SROs are required to notify the Securities Investor Protection Corporation when they become aware of facts that lead them to believe that any broker-dealer subject to their regulation is approaching financial difficulty, and the SROs must undertake certain oversight responsibilities with respect to such broker-dealers.<sup>122</sup> Once again, SRO immunity for actions taken pursuant to this statutory obligation is limited to those "taken or omitted in good faith."<sup>123</sup>

Thus, Congress has not immunized SROs from all liability for defamatory statements contained in reports required by law. Only in the context of fulfilling their quasi-judicial functions are SRO officials and personnel accorded full immunity from tort liability.<sup>124</sup> It is difficult to discern why a broker-dealer's completion of a Form U-5 — a step far removed from any SRO quasi-judicial function — is deserving of absolute protection from tort liability.

### V Conclusion

As the Seventh Circuit noted in *Baravati*, an absolute privilege is "strong medicine," and a compelling case has not been made for extending the privilege beyond the judicial and quasi-judicial context into the area of Form U-5 reporting,<sup>125</sup> especially given the abuses that have sometimes occurred with respect to such reporting. Given the possibility of such abuses and the very serious damage that improper Form U-5 reporting can do to individuals' business reputations and employment prospects, immunizing broker-dealers from all liability for defamatory Form U-5 statements would afford insufficient protection to the reputational interest of individuals employed in the securities industry. Any response to Form U-5 defamation concerns must balance these reputational interests, securities regulators' need for accurate and complete information about the movements of problem

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120. 15 U.S.C. § 78o-3(i) (Supp. V 1993).

121. *Id.* §§ 78aaa-III (1988).

122. *Id.* § 78eee(a)(1) & (2) (1988).

123. *Id.* § 78iii(b) (1988).

124. *See Austin Municipal Sec., Inc. v NASD*, 757 F.2d 676, 697 (5th Cir. 1985) (holding that absolute immunity applies to actions taken within outer scope of disciplinary duties, but that no immunity applies for actions taken outside of that authority).

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

representatives, and broker-dealers' desire for protection against civil liability for good-faith errors in Form U-5 reporting. To achieve such a balance, Form U-5 statements should enjoy only qualified protection from defamation liability

