

Defamation on Form U-5: Caught Between A Rock and a Hard Place

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If you're not careful, putting a black mark on someone's form U-5 can be a very costly mistake. In a number of recent cases, negative information on a U-5 has triggered lawsuits for defamation in which the plaintiffs won millions of dollars. To reduce your exposure, you need to understand the landscape and then implement several proactive measures.

The Dilemma

In most industries, when one of our clients fires someone for misconduct, we advise that if any prospective new employer requests a job reference, discretion is the better part of valor. Stick to "name, rank and serial number." Confirm the person's hire date, termination date and title, but say nothing more. This reduces the risk of being sued for defamation.

Unfortunately, if you are a member of the Financial Industry Regulatory Authority (FINRA), sticking to "name, rank and serial number" is not an option. When a registered representative terminates employment or ceases to be your agent, you must file a Form U-5. If the rep was discharged or "permitted to resign," the U-5 requires you to describe the specific reason for that action. It also requires you to disclose whether he or she was accused of, or investigated for, offenses such as fraud. FINRA can fine you for failing to comply with these disclosure obligations.

That leaves employers in this industry caught between a rock and a hard place. If you fail to candidly disclose the misconduct that led to a discharge, you can get into trouble with FINRA. On the other hand, if you fully disclose that

misconduct, it invites a defamation lawsuit from the person you fired, especially if the rep feels he or she was innocent, or feels you exaggerated the offense.

Big Money At Stake

A black mark on a registered rep's U-5 can make it difficult if not impossible to find another job in the industry. As a result, if the rep wins a defamation claim, he or she may have large damages. In the past few years, there have been several publicized cases in which reps won millions of dollars for U-5 defamation.

Company	Accusation on U-5	Damages Awarded
Waddell & Reed	Embezzling client funds	\$27.5 million
Merrill Lynch	Market timing	\$14.0 million
AllianceBernstein	Market timing	\$12.0 million
UBS	Market manipulation	\$ 2.5 million
Merrill Lynch	Discretionary authority	\$ 1.6 million

The "Qualified Privilege" Defense Rarely Succeeds In Arbitration

Candid U-5s are valuable to society, so the law encourages employers to be forthcoming by cloaking statements on a U-5 with a "qualified privilege." In theory, that offers some protection: the author is only liable if he or she acted recklessly. A false statement is not actionable if the mistake was due to simple negligence.

In many contexts, requiring proof of recklessness genuinely protects against liability, especially when a media defendant stands accused of defaming a politician or a celebrity.

"Our clients have achieved significant savings on litigation costs when they follow this advice."

Unfortunately, the qualified privilege defense is less successful with U-5s. There are several reasons, including: (a) state law, not federal, governs; and (b) U-5 defamation claims usually are resolved by arbitrators, not a court.

“You can be truthful in a prudent, tactful way. Don’t bludgeon the discharged rep and dare him to sue you.”

First, in the media cases, federal law imposes limits to safeguard Freedom of Speech. A plaintiff must show that the author “recklessly disregarded the truth.” This requires proof that the author: (a) knew the statement was false; or (b) consciously realized there was a high probability it was false (*e.g.*, was aware of facts that contradict what he or she said); or (c) had no idea whether it was true or false (*e.g.*, just speculated or guessed). However, U-5 defamation claims are governed solely by state law. In many states, a plaintiff merely needs to show that: (a) the employer’s investigation was inadequate; or (b) it carelessly said more than needed; or (c) it was motivated by ill will or spite.

Second, the qualified privilege defense rests on a subtle intellectual distinction between negligence and recklessness. In our experience, it is easier to sell that type of defense in a summary judgment motion than at a trial. That is a problem, because most U-5 defamation claims are subject to FINRA arbitration, where summary judgment is very rare.

Finally, arbitrators are not bound to strictly follow the law. If a U-5 contains a false statement, arbitrators may feel it is “unfair” to let the employer off the hook based on a technicality, which is how they may view the qualified privilege defense. In sum, this defense looks great on paper, but in practice, it rarely carries the day when U-5 defamation claims are arbitrated at FINRA.

Rosenberg To The Rescue — But Only In New York

Last year, in a seminal decision, New York’s highest court held that statements on a U-5 are protected by an “absolute privilege,” not just a “qualified privilege.” *Rosenberg v. MetLife*, 8 N.Y. 3d 359 (N.Y. 2007). That is the strongest

possible privilege, the same one judges enjoy for rulings they make in court. It means an employer cannot be held liable for defamation for anything it writes on a U-5, not even if it knows the statement is false and deliberately lies.

Many employers breathed a sigh of relief when they learned about *Rosenberg*. Alas, this case is not a nationwide panacea. If the rep worked in any state other than New York, *Rosenberg* won’t help. So far, no other state has adopted an absolute privilege for U-5s; elsewhere, the qualified privilege remains in effect. Thus, despite *Rosenberg*, companies in this industry will continue to be sued for defamation over what they say in Form U-5.

An Ounce Of Prevention

Prevent your organization from filing inflammatory U-5s. You must be truthful on a U-5, but you can be truthful in a prudent, tactful way. Don’t bludgeon the discharged rep and dare him to sue you.

Hypothetical example: An agent falsifies a form by signing the client’s name on it. The client gave him permission, but under your compliance rules it’s still a violation, despite “permission,” so you fire him. The box below lists two ways you could describe the reason for this discharge.

COMMON:

“Falsified a client’s signature on a form.”

PRUDENT:

“Signed a client’s name on a form, which violates company policy even though the client gave permission.”

Both are truthful, but the “prudent” version is less likely to get you sued. Why?

1. It uses softer, less inflammatory language: “signed” instead of “falsified.”
2. It adds an exculpatory detail (“permission”).

In some people’s eyes, especially the rep’s, that might make the accusation appear less serious. At a minimum, it prevents the U-5 from being misconstrued as accusing the rep of forgery.

Tips To Protect Yourself

In our experience, when left to their own devices, most managers draft something akin to the “common” version. To reduce your exposure, you want to change that orientation, or at least catch and edit out provocative language before the U-5 is filed. How do you achieve that goal?

- ▶ Train your managers about the risks of a U-5 defamation lawsuit.
- ▶ Create a U-5 review team.

For maximum effectiveness, your review team should include both an in-house attorney and a compliance person. Also, to minimize the burden, you should have a lower level “screener,” so senior people don’t waste their time reviewing routine, innocuous U-5s. Our clients have achieved significant savings on litigation costs when they follow this advice. If you want assistance in developing a review procedure or training your team members, we’d be happy to help.

If you have questions about a U-5 matter please feel free to contact one of our Labor & Employment lawyers listed below or your regular contact at Drinker Biddle for further guidance.

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