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Securities Law Update – December 2007

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Scope of General Release Language

In a December 14, 2007 decision, a New York federal court held that the failure to include a reservation of rights clause, or to limit the scope of release language, resulted in the setting aside of a \$4.7 million default judgment. [Barone v. Marone](#), 2007 U.S. Dist. LEXIS 92350 (S.D.N.Y. Dec. 14, 2007). After obtaining an NASD award against Mr. Marone's former employer, and a subsequent settlement for \$3.3 million, the Claimants in the underlying arbitration attempted to obtain a second "bite of the apple" from the original "bad guy", Mr. Marone. Although the Claimants initially obtained a default judgment, Mr. Marone successfully moved pursuant to Fed.R.Civ.P. 60(b)(5) for relief from the judgment. Finding that all claims against Mr. Marone were encompassed within the Release, the default judgment was vacated.

Exclusion of Evidence Regarding Negotiation of U-5 Language Affirmed

In [Galarneau v. Merrill Lynch](#), provided below, the First Circuit affirmed a district court's exclusion of evidence related to the parties' attorneys' negotiation of a Form U-5's termination language. The issue arose in the context of a defamation claim related to the termination of a former stockbroker. Merrill Lynch wanted to introduce evidence of the negotiation of the termination language to be placed on the Form U-5. The stockbroker objected to the evidence, arguing that it constituted a Rule 408 settlement negotiation. The trial and appellate courts agreed with the stockbroker. Especially interesting about the opinion is the glimpse it provides into the reality of how termination language is placed on a broker's permanent record, and the role lawyers can play with the negotiation of the termination language. More often than not, brokers do not bother to retain counsel quickly enough, and are left to the whim of their former employers.

Should Stockbrokers be Permitted to Rewrite History?

A hot topic in the securities industry for several years has been the practice of having the CRD Reports of individual brokers routinely expunged following the settlement of securities arbitrations.

Expungement can mean that one day one's record reflects the existence of a customer complaint, and the next day, all evidence of the complaint vanishes. In [UBS Financial Services v. NASD Dispute Resolution](#), UBS attempted to confirm such an expungement, but was met by the New York Attorney General's Motion for Leave to Intervene. The New York Attorney General's Motion was granted, giving the Attorney General the right to argue that the NASD should not be permitted to grant the expungement directed by a panel of NASD arbitrators. It will be interesting to see whether the ultimate result of this case has consequences beyond the specific case.

Preemption Precludes Stockbroker Class Action

A [District of Columbia District Court](#) dismissed stockbrokers' suit alleging state law claims arising from incorrect scoring of the Series 7 licensing examination. Interesting discussion contrasting preemption and immunity.

LOUIS S. BARONE, ET AL., Plaintiffs, - against - FRANKLIN S. MARONE, MARITA S. MARONE, and PATROLLER'S CAPITAL FUND, Defendants.

04 Civ. 2001 (NRB)

**UNITED STATES DISTRICT COURT FOR THE SOUTHERN
DISTRICT OF NEW YORK**

2007 U.S. Dist. LEXIS 92350

**December 14, 2007, Decided
December 14, 2007, Filed**

CORE TERMS: settlement, general releases, default judgment, arbitration, satisfaction, attorney fees, default, unambiguous, mutual, compensatory, matter of law, tortfeasor, partially, extrinsic, arbitration award, reasons stated, reasonable time, pro se, conclusory, dealer, former representatives, former employees, causes of action, restitution, affiliated, successor, punitive, vacatur, entities, contract interpretation

JUDGES: NAOMI REICE BUCHWALD,
UNITED STATES DISTRICT JUDGE.

OPINION BY: NAOMI REICE BUCHWALD

OPINION

MEMORANDUM AND ORDER

NAOMI REICE BUCHWALD

UNITED STATES DISTRICT JUDGE

Franklin S. Marone ("Marone" or "defendant") moves pursuant to Fed. R. Civ. P. 60(b)(5) for relief from a \$ 4,748,165.11 default judgment awarded to the plaintiffs on August 11, 2005. Marone contends that the judgment has been either satisfied or released following an arbitration award rendered by the National Association of Securities Dealers in favor of the plaintiffs and against his former employers, Carlin Equities Corporation ("Carlin") and Generic Trading, Philadelphia, LLC ("Generic"). For the reasons stated herein, Marone's motion is granted.

BACKGROUND

Plaintiff-investors filed this action in March of 2004 seeking compensatory and punitive damages arising out of Franklin Marone's use of an investment fund, the Patrollers Capital Fund (the "Fund"), to

defraud them of approximately \$ 4.7 million.¹ After the defendant failed to answer, plaintiffs moved for a default judgment. On August 11, 2005, the motion was granted to the extent of compensatory damages in the amount of \$ 4,748,165.11, but denied insofar as it related to punitive damages and attorney fees.

1 Marone induced members of the ski patrol at Windham Mountain Ski Resort in Windham, New York, and their family and friends, to invest in the Fund and thereafter diverted virtually all of their investments to his personal bank accounts. The defendant's fraud did not escape the attention of state and federal authorities. Several weeks before the plaintiffs filed their complaint, the United States Securities and Exchange Commission brought an enforcement action to enjoin the Fund's continuing operation and eventually obtained partial consent judgments against the defendant. At the state level, Marone was indicted for fraud and grand larceny and, after pleading guilty to those charges, sentenced to a prison term of six to eighteen years. The state court also entered a restitution order against Marone in the amount of \$ 4,669,458.77.

Almost a year after initiating this action, plaintiffs filed a claim with the National Association of Securities Dealers ("NASD") seeking arbitration of several causes of action, including respondeat superior liability for intentional torts committed by an employee, negligent hiring, negligent supervision, and negligent retention, asserted against defendant's employers Carlin and Generic ("NASD Arbitration"). On June 13, 2006, the NASD panel rendered an award of \$ 3,000,000 in

compensatory damages, but explicitly rejected the plaintiffs' request for attorney fees and punitive damages. Shortly thereafter, Carlin and Generic filed a petition for vacatur of the arbitration award in the Supreme Court of New York, County of New York and the plaintiffs filed a cross-petition to confirm the award.

In September of 2006, Carlin, Generic, and the plaintiffs executed a Mutual General Release and Settlement Agreement (the "Agreement"). In consideration of a full and final resolution of the NASD and state court proceedings, Carlin Owners Corp. agreed to a lump sum payment of \$ 3,310,000 due to the plaintiffs by the end of September.² The Agreement also included mutual general releases, not limited to the settled disputes. The plaintiffs' release, for example, insulated Carlin Owners Corp. and its affiliated entities' present and former representatives and agents from liability for all existing actions, suits, proceedings and causes of action as well as all damages, judgments, and defaults entered prior to the date of the Agreement.³ The stated intention of the parties in executing the general releases was to achieve a "full and final accord, satisfaction, and release."

2 Carlin and Generic are affiliated entities of Carlin Owners Corp.

3 Section 2 of the Agreement provides:

Release by Claimants.

Claimants for themselves and their present and former representatives, agents, attorneys, predecessors, successors, insurers, administrators, heirs, executors and assigns,

hereby release, acquit and forever discharge Respondents, Carlin Owners Corp., Carlin Equities LLC., (the successor broker/dealer to Carlin Equities Corporation) and any and all affiliated entities and their present and former representatives, agents, attorneys, predecessors, successors, insurers, administrators, heirs, executors and assigns of and from all manner of actions, suits, proceedings, and causes of action, in law or in equity, whether foreseen or unforeseen, matured or unmatured, known or unknown, accrued or not accrued, and of and from all direct or indirect debts, assessments, dues, claims, losses, damages, judgments, executions, defaults, covenants, contracts, controversies, agreements, promises, attorney's fees, costs, interest payments and expenses, accounts, bills, variances, trespasses, assignments, notes, leases, rights, liabilities, obligations, and demands, up to the date of this Mutual General Release and Settlement Agreement.

It is the intention of the Parties in executing this instrument that this instrument shall be

deemed effective as a full and final accord, satisfaction and release.

Marone was not a party to the NASD Arbitration, nor was he otherwise involved in that proceeding. He learned of the arbitration award against his employers from an article published in the New York Post on July 27, 2006 that reported Marone's scheme, the outcome of the NASD Arbitration, and Carlin and Generic's plans to "appeal" the panel's ruling.⁴ There is no indication that Marone was specifically aware of the settlement and general release, as opposed to the NASD award itself, until the plaintiffs served their opposition brief which attached the Agreement and related NASD Arbitration filings as exhibits.⁵

4 See Paul Tharp, *Abominable Snow Job Costs Merrill*, N.Y. Post, July 27, 2006, at 40.

5 Indeed, confidentiality provisions in the Agreement restricted the disclosure of its contents as well as the underlying facts, communications, and negotiations. There were, however, limited carveouts for responding to judicial process and to inquiries from regulatory, administrative or governmental agencies.

DISCUSSION

I. Legal Standard

Federal Rule of Civil Procedure 60(b) codifies the post-judgment remedies available to a party seeking relief from a final judgment and specifically contemplates the situation where "the

judgment has been satisfied, released, or discharged." Fed. R. Civ. P. 60(b)(5). If the party seeking relief proceeds by motion in the rendering court, such a motion must be made within a "reasonable time" after entry of the judgment. Fed. R. Civ. P. 60(c)(1).

Rule 60(b) motions are ripe for summary judgment when "there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c); see, e.g., *Okemo Mountain, Inc. v. United States Sporting Clays Ass'n*, 376 F.3d 102, 105 (2d Cir. 2004). Though the Court is obligated to view all facts in the light most favorable to the nonmoving party, see *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 255 (1986), the nonmoving party "may not rest upon mere conclusory allegations or denials, but must bring forward some affirmative indication that his version of relevant events is not fanciful." *Podell v. Citicorp Diners Club, Inc.*, 112 F.3d 98, 101 (2d Cir. 1997) (internal quotation marks omitted).

Mindful of our obligation to liberally construe the papers filed by *pro se* litigants, *Marmolejo v. United States*, 196 F.3d 377, 378 (2d Cir. 1999), we perceive two independent bases upon which Marone could seek relief from this Court's August 11, 2005 judgment: (i) Carlin and Generic's payment of the settlement amount in the Agreement may constitute partial satisfaction of that judgment; and (ii) the plaintiffs' general release may extend to Marone, a former "agent" or "representative" of Carlin and Generic. We first consider whether Marone's motion was filed within a reasonable time and then turn to evaluate whether the judgment has been satisfied or released.

II. Marone's Motion Was Timely.

What qualifies as a "reasonable time" under Rule 60(c) depends on the circumstances of each case. See *In re Emergency Beacon Corp.*, 666 F.2d 754, 760 (2d Cir. 1981) (twenty-six month delay reasonable); see also *Graham v. Sullivan*, No. 86 Civ. 163, 2002 WL 31175181, at *1 (S.D.N.Y. Sep. 23, 2002) (*pro se* party's nineteen month delay unreasonable); *Peyser v. Searle Blatt & Co.*, No. 99 Civ. 10785, 2001 WL 1602129, at *2 (S.D.N.Y. Dec. 14, 2001) (*pro se* party's sixteen month delay unreasonable). Courts take into account such factors as the length of the delay, notice to the moving party of the changed circumstances forming the basis for the motion, and the possibility of prejudice to the opposing party. See *In re Emergency Beacon Corp.*, 666 F.2d at 760.

Marone's motion is timely under the circumstances. Given Carlin and Generic's reported intention to seek vacatur of the NASD Arbitration award, it would not have been unreasonable of Marone, even had he known of the arbitration, to wait until any state court actions and subsequent appeals had run their course. Accordingly, the parties' dismissal of the state court proceeding in October of 2006, at least in theory, placed Marone on constructive notice of a settlement that might impact the judgment against him. However, considering Marone's indigence and incarceration, the confidentiality provisions in the Agreement, and the lack of any clear prejudice to the plaintiffs, we cannot say that a nine-month delay from that time was unreasonable.

III. The Settlement Partially Satisfied The Default Judgment.

The Second Circuit has adopted the "one satisfaction rule," which prohibits a plaintiff from recovering more than one

satisfaction for each injury. See *Gerber v. MTC Electronic Technologies Co., Ltd.*, 329 F.3d 297, 302-03 (2d Cir. 2003).⁶ "Where there has been only one injury, the law confers only one recovery, irrespective of the multiplicity of parties whom or theories which the plaintiff pursues." *Kassman v. American University*, 546 F.2d 1029, 1033-34 (D.C. Cir. 1976). The plaintiff's settlement with another tortfeasor who, together with defendant, caused a single indivisible harm entitles the defendant to relief under Rule 60(b)(5) in the form of a judgment credit. See *Kassman v. American University*, 546 F.2d at 1033-34 (granting relief under 60(b)(5) where settlement partially satisfied judgment); see also *In re Masters Mates & Pilots Pension Plan and IRAP Litigation*, 957 F.2d 1020, 1031 (2d Cir. 1992) ("[W]here a settlement and a judgment compensate a plaintiff for the same injury, a nonsettling defendant is entitled to a judgment reduction, at least in the amount of a prior settlement."). Accordingly, Carlin and Generic's settlement with the plaintiffs partially satisfied Marone's judgment as a matter of law so long as the defendants' conduct resulted in a single harm.

6 Federal law governs the question of whether a defendant in a federal securities action is entitled to a judgment credit for the settlement of a separate action by another party to the dispute. See *Singer v. Olympia Brewing Co.*, 878 F.2d 596, 599-600 (2d Cir. 1989).

There is no question that the settlement payment and the August 11, 2005 judgment compensate the plaintiffs for the same injury. The plaintiffs' NASD Arbitration statement of claim requests compensatory relief in the amount of \$ 4.7 million, the same amount sought by the plaintiffs in their default judgment motion in

this case. Though the plaintiffs' losses may have been caused by all three "defendants" -- Marone's fraud and Carlin and Generic's negligence in hiring, retaining and supervising Marone -- there are no factual distinctions between the injuries resulting from their alleged conduct: the \$ 4.7 million loss represents a single, indivisible harm. Thus, Marone is entitled, at a minimum, to a \$ 3,310,000 reduction of the August 11, 2005 judgment,⁷ unless we further conclude that the plaintiffs' general release completely extinguishes their claim.

7 Plaintiffs effectively concede that the August 11, 2005 judgment has been partially satisfied, but dispute the amount of the credit to be applied. They argue that attorney fees totaling \$ 1,180,000 should not be deducted from the judgment amount because that sum was not received by the plaintiff-investors, but paid to plaintiffs' counsel.

Even assuming that plaintiffs' counsel received that fee, the state litigation and settlement followed an NASD arbitral award that did not shift the plaintiffs' attorney fees to the defendants. Likewise, our August 11, 2005 memorandum and order denied the plaintiffs' motion for attorney fees to accompany the default award of compensatory damages. Clearly, any payment by the plaintiffs to their counsel was part of a contractual arrangement between them.

Under the circumstances, we see no reason to undermine the default "American Rule" disfavoring the shifting of attorney fees to prevailing litigants. See *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 247, 95 S.Ct. 1612

(1975). The parties shall continue to bear their own fees and costs in accordance with the NASD panel ruling and this Court's prior decision.

IV. Plaintiffs Released Marone From All Liability Predating The Settlement.

In matters of contract interpretation, "[s]ummary judgment is generally proper . . . only if the language of the contract is wholly unambiguous." *Compagnie Financiere de CIC et de L'Union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 232 F.3d 153, 157 (2d Cir. 2000). The interpretation of ambiguous contract language must be resolved by the fact-finder unless the non-moving party fails to support its asserted interpretation with relevant extrinsic evidence or the evidence presented by the parties is so one-sided that no reasonable person could decide to the contrary. *Id.* (citing cases).

The Agreement included a general release of all existing judgments and defaults entered against Carlin and Generic's former agents and representatives. Though plaintiffs acknowledge the breadth of that release, they nonetheless contend that it should not be read so expansively as to relieve Marone of liability for any conduct outside the scope of his employment with Carlin and Generic. For the reasons stated herein, we are not persuaded that the release was so limited.

A. The General Release Is Unambiguous.

A release is merely a species of contract and, as such, its interpretation is governed by general principles of contract law. See *Mangini v. McClurg*, 24 N.Y.2d 556, 562, 301 N.Y.S.2d 508 (1969); *Aetna Cas. & Sur. Co. v. Jackowe*, 96 A.D.2d 37,

468 N.Y.S.2d 153 (2d Dept. 1983); see also *Wells v. Shearson Lehman/American Express, Inc.*, 72 N.Y.2d 11, 21-22, 530 N.Y.S.2d 517 (1988). "The fundamental, neutral precept of contract interpretation is that agreements are construed in accord with the parties' intent." *Greenfield v. Philles Records, Inc.*, 98 N.Y.2d 562, 569, 750 N.Y.S.2d 565 (2002). The best evidence of intent is the contract itself; if an agreement is "complete, clear and unambiguous on its face[, it] must be enforced according to the plain meaning of its terms." *Id.*; see also *Golden Pacific Bancorp v. F.D.I.C.*, 273 F.3d 509, 514-15 (2d Cir. 2001). Whether an ambiguity exists is a question for the court to decide as a matter of law by considering whether the terms of the release are "capable of more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement." *Id.* at 517 (quotation marks and citation omitted).

Here, the general release is unambiguous and sufficiently broad to discharge Marone's liability for the August 11, 2005 judgment. All existing judgments and defaults against Carlin and Generic's "present and former" agents and representatives, regardless of their status as parties to the NASD arbitration, were subject to the general release.⁸ Because Marone was an employee of Carlin and Generic and a default judgment on the plaintiffs' claims against him was entered well over a year before the Agreement was executed, the plain language of the release compromises that judgment.

⁸ Under New York law, a release given to one tortfeasor does not discharge any other tortfeasor liable for the same injury unless the terms of the release "expressly so provide." N.Y. General Obligations Law § 15-

108. However, the release need not specifically name or identify a joint, successive or vicarious tortfeasor that caused the harm. *Wells*, 72 N.Y.2d at 21-22, 526 N.E.2d at 13-14; *Tufail v. Hionas*, 156 A.D.2d 670, 549 N.Y.S.2d 436 (2d Dept. 1989).

Any uncertainty in this regard is easily resolved when the terms at issue are understood within the context of the entire agreement. For one thing, the parties' general releases were asymmetric. The terms "representatives" and "agents" were not modified by "present and former" in Carlin and Generic's release, suggesting that the plaintiffs' release of former employees was the subject of some discussion or negotiation while the Agreement was being drafted. Despite the outstanding default judgment against Marone, which clearly presented the potential for future enforcement or vacatur proceedings, the parties did not reserve any rights against Marone or otherwise narrow the release. The failure to expressly limit the scope of the release in the face of Carlin and Generic's concern for subsequent litigation involving its former employees is compelling evidence of the parties' intent to release Marone from liability.

The statement of the parties' intention immediately following the mutual releases in the Agreement is also instructive: "[T]his instrument shall be deemed effective as a full and final accord, satisfaction and release." The parties must have contemplated that the settlement and release would finally and completely resolve the plaintiffs' claims arising out of Marone's fraudulent conduct, because any contrary interpretation of that statement would expose Carlin, Generic, and the plaintiffs to further litigation.⁹ That result would be inconsistent with the parties'

expectation of a "full and final" resolution of any claim the plaintiff had against Carlin, Generic, and its current and former employees.

9 Carlin and Generic may become embroiled in plaintiffs' attempts to enforce the default judgment, oppositions to motions filed by Marone to vacate or otherwise set aside that judgment, or (had we ruled differently) trial on the instant motion to ascertain the parties' intentions in drafting the mutual releases. See, e.g., *Okemo Mountain, Inc.*, 376 F.3d at 105; *Golden Pacific Bancorp*, 273 F.3d at 514-15. Indeed, though the plaintiffs have not done so, the opposition papers might have been supported by affidavits from Carlin and Generic regarding both their litigation position with respect to Marone's agency and their intentions as to the scope of the release in the Agreement. Avoiding such intrusions is squarely within the intended domain of general releases as broad as the one executed by the plaintiffs.

Moreover, under New York law, the express reference to "agents" or "representatives" in a general release executed by the principal entirely discharges the agents' liability for any disputes within the scope of the release. See, e.g., *Berkowitz v. Fischbein, Badillo, Wagner & Harding*, 7 A.D.3d 385, 387, 777 N.Y.S.2d 99, 101-02 (1st Dept. 2004) (holding separate fraud action against agents precluded by principal's general release of "agents" and "representatives"); *Argyle Capital Management Corp. v. Lowenthal, Landau, Fischer, & Bring, P.C.*, 261 A.D.2d 282, 283, 690 N.Y.S.2d 256, 257 (1st Dept. 1999); cf. *Okemo Mountain, Inc.*, 376 F.3d at 104-05 (applying Vermont law). Particularly in light of the parties'

stated intention to achieve global peace, we believe that New York courts would hold that the plaintiffs' release was unambiguous as a matter of law and discharged the judgment against Marone.

B. Plaintiffs' Conclusory Assertions In Support Of Their Proposed Interpretation Are Unavailing.

Even assuming *arguendo* that the release is ambiguous, the plaintiffs have failed "to point to *any* relevant extrinsic evidence supporting [their] interpretation of the language" at issue. *Compagnie Financiere de CIC et de L'Union Europeenne*, 232 F.3d at 157 (emphasis added); see also *Doe v. National Bd. of Podiatric Medical Examiners*, No. 03 Civ. 4034, 2004 WL 912599, at *7 (S.D.N.Y. April 29, 2004); *Ananta Group, Ltd. v. Jones Apparel Group, Inc.*, No. 01 Civ. 674, 2001 WL 648926, at *6 (S.D.N.Y. June 11, 2001). In the absence of extrinsic evidence suggesting that the release should be narrowly construed,¹⁰ the plaintiffs' bare and conclusory assertions as to the parties' intentions are insufficient to withstand summary judgment.

10 The plaintiffs were given two opportunities to proffer such evidence. The initial opposition to Marone's motion did not raise any arguments with respect to the scope of the release, attached as an exhibit to that submission. We noted this deficiency and requested supplemental briefing on the issue. The plaintiffs then responded by advancing an interpretation of the relevant terms without submitting any supporting affidavits or other extrinsic evidence of the parties' intent.

This result is not only compelled by the language of the release, but also accords

with the historic record and practical reality. By the time Carlin, Generic, and the plaintiffs had signed the Agreement, there was a restitution order against Marone in the amount of \$ 4,669,458.77, which would take precedence over any civil judgment obtained by these plaintiffs. Satisfaction of Marone's restitution obligation would prevent additional recovery under the "one satisfaction rule." Quite simply, there was no reason to reserve any rights under the release.

To the extent the parties to the release considered the issue of Marone's agency, the premise underlying the plaintiffs' argument - Marone was acting outside the scope of his employment rather than as an agent of either firm -- is flawed. Far from alleging that Marone acted *ultra vires*, the amended complaint related how Marone repeatedly held himself out to the public as an experienced investment advisor and trader employed by Carlin and Generic.¹¹ The plaintiffs, now contending that Marone was not acting as an agent while engaged in the illegal conduct, took the opposite position in the NASD litigation in order to support their respondeat superior claim. Since Marone defaulted without appearing in the case and the NASD panel did not issue an opinion or otherwise set out their rationale for the award, the issue has not been formally adjudicated.¹²

11 It is axiomatic that "a principal, even if innocent, is liable for acts of fraud that are within the scope of an agent's actual or apparent authority." *Chubb & Son Inc. v. Consoli*, 283 A.D.2d 297, 298, 726 N.Y.S.2d 398 (1st Dept. 2001).

12 A trial on that issue, as with that on the scope of the release, would defeat the parties' desire for a "full and final" resolution of the matter.

Thus, there was never any basis for the parties to the release to conclude that Marone's fraudulent conduct was necessarily outside the scope of his employment and that the default judgment would be unaffected by the release of Carlin and Generic's "agents" or "representatives". Indeed, the plaintiffs' failure to include an express reservation of rights against Marone in his individual capacity, a likely request given the uncertainty surrounding the default judgment, further suggests that the parties did intend to release Marone.

CONCLUSION

For the reasons stated above, pursuant to Fed. R. Civ. P. 60(b)(5), the default judgment entered against Franklin Marone by this Court on August 11, 2005 is hereby released and vacated.

IT IS SO ORDERED.

Dated: New York, New York

December 14, 2007

/s/ Naomi Reice Buchwald

NAOMI REICE BUCHWALD

UNITED STATES DISTRICT JUDGE

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**DEBORAH GALARNEAU, Plaintiff, Appellee, v. MERRILL LYNCH, PIERCE, FENNER
& SMITH INC., Defendant, Appellant.**

No. 06-2410

**UNITED STATES COURT OF APPEALS FOR THE FIRST
CIRCUIT**

**504 F.3d 189; 2007 U.S. App. LEXIS 23919; 155 Lab. Cas. (CCH)
P60,509; 26 I.E.R. Cas. (BNA) 1189**

October 12, 2007, Decided

PRIOR HISTORY:

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MAINE. [Hon. William S. Brownell, U.S. Magistrate Judge], and [Hon. George Z. Singal, U.S. District Judge].
Galarneau v. Merrill Lynch Pierce Fenner & Smith, 2006 U.S. Dist. LEXIS 36552 (D. Me., June 6, 2006)

DISPOSITION: Affirmed in part;
Reversed and Vacated in part.

CASE SUMMARY:

PROCEDURAL POSTURE: After appellee stockbroker was fired from her job and appellant employer reported that the stockbroker had engaged in inappropriate bond trading, the stockbroker sued the employer for defamation. A jury in the United States District Court for the District of Maine found for the stockbroker, awarded her compensatory and punitive damages, and denied the employer's motion for judgment as a matter of law. The employer appealed.

OVERVIEW: On appeal, the employer argued that the jury's verdict could not stand because the stockbroker failed to show that its statement was false and malicious, two requirements for liability under Maine's common law of defamation. The court found that the evidence was sufficient to support the jury's verdict in favor of the stockbroker on her defamation claim and affirmed the district court's denial of the employer's motion for judgment as a matter of law where: (1) the expert testimony that the stockbroker's trading was appropriate, even if active, was strong evidence that the employer's statement on the Uniform Termination Notice for Securities Industry Registration (U-5 Form) was false; (2) the evidence of the employer's continuous approval of the stockbroker's trading strategy while the account was at its most active also supported the jury's ultimate conclusion that the U-5 Form was false; and (3) evidence that the employer approved the trading as it was taking place and defended the trading after it came under attack supported the jury's conclusion that the firm either knew the statement was false, or recklessly disregarded its falsity.

OUTCOME: The district court's denial of the employer's motion for judgment as a matter of law was affirmed with respect to (1) the sufficiency of the evidence supporting the jury's finding of defamation and (2) the award of special damages. The district court's exclusion of evidence was affirmed. The district court's denial of judgment as a matter of law was reversed on the punitive damages question.

CORE TERMS: trading, defamation, punitive damages, malice, falsity, conditional privilege, inappropriate, terminated, matter of law, special damages, defamatory statements, actual malice', common law, reckless disregard, clear and convincing evidence, outrageous, probative, termination, portfolio, evidence to support, times, fixed income, triggered, margin, stock, swap, pure, jury verdict, compensatory damages, privileged

LexisNexis(R) Headnotes

COUNSEL: Evan M. Tager, with whom Andrew Tauber, Mayer, Brown, Rowe & Maw LLP, James R. Erwin, Pierce Atwood LLP, and Eugene Volokh, UCLA School of Law, were on brief, for appellant.

Rufus E. Brown, with whom Brown & Burke, Michael A. Nelson, and Jensen Baird Gardner & Henry, were on brief, for appellee.

JUDGES: Before Torruella, Circuit Judge, Newman, * Circuit Judge, and Lynch, Circuit Judge.

* Of the Federal Circuit, sitting by designation.

OPINION BY: TORRUELLA

OPINION

TORRUELLA, Circuit Judge. On January 6, 2004, Deborah Galarneau ("Galarneau") was fired from her job as a stockbroker at Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch"). In a form submitted to the National Association of Securities Dealers ("NASD"), Merrill explained that "Ms. Galarneau was terminated after the firm concluded that she had (I) engaged in inappropriate bond trading in one client's account and (II) utilized time and price discretion in the accounts of three clients." Galarneau brought this action against Merrill Lynch in the United States District Court for the District of Maine, alleging defamation (among other claims). The jury found in favor of Galarneau, awarding compensatory and punitive damages. Merrill Lynch moved for judgment as a matter of law, challenging the finding of defamation and the award of special and punitive damages. The district court denied the motion. After careful consideration, we affirm the district court's denial with respect to the finding of defamation and the award of special damages, but reverse with respect to the jury's award of punitive damages.

I. FACTUAL BACKGROUND

Because Merrill Lynch challenges the sufficiency of the evidence, we recite the facts in the light most favorable to the verdict. See *Wilson v. City of Boston*, 421 F.3d 45, 48 n.2 (1st Cir. 2005). Deborah Galarneau was employed at Merrill Lynch's Portland, Maine branch office from February 1989, when she joined her husband Preston Galarneau at the firm,

until she was terminated on January 6, 2004. Beginning in 1998, the Galarneaus worked as a team called the "Galarneau Group," as allowed by Merrill Lynch. Galarneau was successful as a financial advisor at Merrill Lynch, ranking in the first or second groupings of producing brokers in her office, qualifying for a \$ 100,000 certificate bonus by growing her business by ten percent for ten consecutive years, and earning other recognition awards and trips.

The Amy Ford Account

Amy Ford became a client of the Galarneau Group in late 2000. Ford was a single woman in her fifties with a portfolio in excess of \$ 2 million, which served as her primary source of income along with other investments not managed by Merrill Lynch. Her portfolio was heavily weighted in nonperforming equities, which Ford had inherited with a low tax basis. Galarneau testified that Ford had a history of spending more than she earned from her investment income. This practice led her to borrow from her investment account and sometimes required her to sell securities to pay off her debt, thereby incurring significant capital gains taxes.

According to Galarneau, she and her husband developed a three-pronged investment plan for Ford's account: first, to rebalance her portfolio to reduce the concentration in legacy stock and increase her investment in fixed income securities (primarily bonds); second, to generate more income for Ford to live on; and third, to minimize the capital gains taxes that would be incurred from the rebalancing.

Galarneau testified that she and her husband told Ford that this investment plan would require aggressive and active trading, including the use of an investment strategy called "tax advantage bond swap"

when the occasions for doing so arose. Tax advantage bond swaps involve selling bonds that have declined in market value (in relation to their cost basis) and using the proceeds of the sale to buy replacement bonds of equivalent or superior investment value. The intended benefit of such a strategy is that the client take tax losses without sacrificing the quality of her investment portfolio. According to Galarneau, in applying this strategy to the Ford account, the Galarneaus expected to use the tax losses to offset any capital gains resulting from the sale of the legacy stock.

The Galarneaus anticipated that the proposed investment plan could be expensive for Ford if she paid commissions on each trade. Galarneau testified that she and her husband advised Ford of the Merrill Lynch Unlimited Advantage ("MLUA") pricing option, a program through which a client could pay a flat annual fee for trading instead of paying commissions on each transaction. According to Galarneau, Ford declined this option and the parties arranged a discount for the commissions for trading in the Ford account.

Merrill Lynch's Review of the Trading in the Ford Account

Galarneau testified that at the outset, she and her husband approached Edward Coppola, then the compliance officer for Merrill Lynch's Northern New England Complex, to discuss the investment strategy for the Ford account. At that time, Coppola did not raise any objections to the proposed investment strategy.

The trading in the Ford account in 2001 and 2002 was very active. During that period, the financial markets were "unusually volatile" in part because of the consequences of the terrorist attacks of

September 11, 2001 and corporate accounting scandals. According to Galarneau, these conditions provided opportunities for tax advantage bond swaps, but also required trades that would not otherwise have been made. In addition, Ford's personal spending was three times in excess of her investment income.

Such active trading triggered management review within Merrill Lynch. The firm uses a computer-generated monitoring system called Armor review, which automatically notifies the Merrill Lynch compliance officers of accounts with unusually active trading. The Armor alert may be accessed from either a financial advisor's computer or a compliance officer's computer. It provides background information about the targeted account, including a summary of the frequency and dollar value of trades (with links to data for individual trades), a comparison of the value of trades versus the commissions earned on the account (the "velocity" of trading), and the commissions for the trading.

The first Armor review took place in July 2001. Coppola asked Galarneau for an explanation of the production credits, the performance, and the strategy. Galarneau provided this information, and Coppola signed off on the trading in the account. According to Galarneau, Coppola never indicated that the trading in the Ford account was inappropriate in any way. Before he left the firm, Coppola reviewed the account again in August 2001 and commented that the account had already been reviewed the previous month.

An Armor review was again triggered the next year, in July 2002, when Richard Heller became the new compliance manager for the Portland, Maine office of Merrill Lynch. Pursuant to the review, Heller specifically asked the Galarneaus

about the "high velocity" in the Ford account. According to Galarneau, the Galarneaus explained the investment strategy for the Ford account, and Heller approved the trading.

This time, as recommended by Merrill Lynch's Policy Manual, Heller sent an "activity letter" to Ford dated September 10, 2002, drawing her attention to (1) the substantial volume of trading in her account, (2) the relatively high level of costs associated with that trading (\$ 29,042) in relation to her portfolio value, and (3) the sizeable level of her margin account ¹ (\$ 203,542). In the letter, Heller asked Ford to confirm that the account was being managed in accordance with her investment objectives and offered to meet with her about the account. Ford never responded. According to Galarneau, she and her husband met with Ford to go over the activity letter, at which point Ford indicated that she was satisfied with how the account was being managed.

1 A "margin account" is a brokerage account in which the broker lends her client cash to purchase securities. The loan is collateralized by the client's securities or cash. If the value of the stock drops significantly, the account holder will be required to deposit more cash or sell a portion of the stock.

A fourth Armor review of the Ford account was triggered in November 2002, which again focused on the substantial volume of trading in the account, including the "high turnover" rate of 6.81%, a very high level of trading. The Galarneaus again explained their strategy of taking as many losses as feasible to offset gains from the sale of legacy stock. Heller checked the box on the Armor review form marked "approved," and noted, "Taking losses,

margin debt decreasing, Letters sent 9-13-02."

This was the last substantive Armor review of the Ford account. By 2003, the level of trading went down, and most of the margin debt incurred by Ford to accelerate the rebalancing had been paid off.

According to Galarneau, the strategy proved successful: The Ford account earned \$ 101,000 from the fixed income investments purchased for Ford, saved more than \$ 36,000 in tax liability as a result of the bond swap strategy, and (as of the time Galarneau was terminated) increased in value by \$ 65,000.

The Ford Complaint

Ford sent Merrill Lynch a letter on June 7, 2003, accusing the Galarneaus and Merrill Lynch of "churning" her account.² Ford copied her complaint to the Maine Securities Division, which promptly opened an investigation into Galarneau, her husband, and Merrill Lynch. In response to this investigation, Merrill Lynch's Office of General Counsel ("OGC") became involved, with Kathleen Durning taking line responsibility, supervised by First Vice President and Assistant General Counsel Andrew Kandel.

2 Specifically, Ford complained that the turnover in her account "is much higher than the experts I have worked with consider reasonable." While acknowledging the need to take tax considerations into account, she stated that "the goal should be taking losses that exist, not creating them."

Merrill Lynch's Response

After receiving explanatory materials from Galarneau and consulting with her,

Durning responded to the Maine Securities Division's initial inquiry with a letter defending the trading in the Ford account. The letter provided detail about the context of the trading in the Ford account consistent with explanations that Galarneau provided for the Armor reviews. It explained the investment objectives of the account, the trading strategy designed to achieve these objectives, the offer to Ford of the MLUA pricing option, the frequent meetings with Ford to review trading, the difficult market conditions, the rationale for the use of margin to implement a rebalancing of the account, the problems created by Ford's excessive personal spending, and other background to the management of the account.

On August 8, 2003, the Maine Securities Division responded with a letter asking for additional explanations and documents relating to the trading in the Ford account. Four days later, counsel for Ford sent Merrill Lynch a letter accusing the firm and the Galarneaus of "churning" with a "disastrous" account performance, and demanding restitution.

On September 8, 2003, Durning wrote the Maine Securities Division another letter, reviewed in draft by Kandel, in response to the Division's earlier inquiry for more information. In this letter, Durning reaffirmed the key points of her July 2, 2003 letter and provided additional support for the legitimacy of the management of the Ford account.

Merrill Lynch's Internal Review

Ford's complaint triggered an internal investigation by Merrill Lynch. Pursuant to this investigation, the firm asked Bates Capital Corporation, an outside firm, to provide a report analyzing the trading in the Ford account on a security-by-security basis (the "Bates report"). For each fixed-

income security that had been traded in the Ford account, the Bates report revealed how long the security had been held, whether it was sold at a profit or loss, whether it was subsequently repurchased and resold and, if so, whether at a profit or loss.

Also pursuant to the internal investigation, Merrill Lynch reviewed Galarneau's personnel file. Heller contacted Jack Michaelian, a former manager, asking for personnel information for Galarneau. He received two memoranda about customer concerns with respect to Galarneau's management of their accounts years earlier. Heller also called a number of Galarneau's clients to determine whether she may have exercised "pure discretion" in managing their accounts.³ From his first round of telephone calls, Heller concluded that Galarneau may have exercised pure discretion in five accounts. Heller sent his findings to Kandel and Scott Gilbert, an attorney in the OGC assigned to the Ford matter.

3 In the securities industry, trading securities without the prior approval of the investor is referred to as taking "pure discretion," and is illegal. Merrill Lynch, as a matter of internal policy, prohibits its brokers from exercising "time and price discretion," which refers to the exercise of discretion as to the exact time and exact price at which a broker executes an order for her client, even with the prior approval of the client. Time and price discretion is not illegal.

As part of the internal review, Galarneau was summoned to the Merrill Lynch corporate headquarters in New York City on October 14, 2003 to be interviewed. According to Galarneau,

Gilbert showed little interest in the reasons for the individual trades in the Ford account and instead focused primarily on whether she had exercised pure discretion in any of her other accounts. Galarneau denied that she had exercised pure discretion, but admitted that she may have unknowingly violated the policy on time and price discretion on two occasions. Galarneau testified that at the conclusion of the interview, Gilbert told her that Merrill Lynch "hoped that they could reach an agreement with Ford's attorney and the case would be settled, and that normally then the State goes away."

While the internal review was in progress, Merrill Lynch reached a settlement with Ford in early November 2003 for \$ 100,000. The Maine Securities Division investigation, however, remained ongoing. On November 7, 2003, the Maine Securities Division sent Merrill Lynch another letter requesting information about Merrill Lynch's supervision of the Galarneaus and inquiring "whether or not the Galarneaus are still employed by Merrill Lynch."

Merrill Lynch terminates Deborah Galarneau

Merrill Lynch terminated Galarneau on January 6, 2004. Edward Hocking, Merrill Lynch's Regional Vice President for the Northern New England Complex and Heller's superior, was responsible for the decision. According to Heller, just before meeting with Galarneau, Hocking told Heller that he had conferred with Merrill Lynch's OGC and that the reasons for the decision to terminate Galarneau were (1) her exercise of time and price discretion; (2) her prior history, as reflected in two personnel memos and "prior warnings";⁴ and (3) the judgment she used in trading in the Ford account. Hocking showed Heller

notes he would use in the meeting detailing these reasons. Galarneau testified that Hocking gave her these same reasons for the termination. According to Galarneau, no specific reference was made in the meeting to inappropriate trading, excessive trading, or churning.

4 Merrill Lynch claims that on at least two occasions before her dismissal, Galarneau's bond trading "had been the object of concern." The firm introduced evidence that in 1998, Galarneau was summoned to a meeting with her office supervisors "to discuss two client complaints, and her trading strategy in regards to bond swaps," and that in 2000, her supervisors warned her not to engage in active bond trading and that Galarneau responded that she would not do so anymore.

According to Galarneau, she was never warned about her trading with respect to bonds. She introduced evidence that the memorandum memorializing the 1998 meeting does not describe a "warning" or criticism of her bond trading generally, and that there is no other memo concerning the 1998 meeting. Galarneau also testified that at the 2000 meeting, Merrill Lynch objected to a specific business plan for bond trading (as opposed to equity trading) for particular clients, but that the firm made no objection to bond trading under other circumstances.

On the same day Galarneau was terminated, Kandel called the Maine Securities Division investigator to report the termination. Kandel recorded in his notes of the conversation that the Maine Securities Division investigator appreciated being informed, saying that it "will have an

impact." The investigator asked Merrill Lynch to confirm the termination in writing. Kandel also requested an opportunity to make a submission to the Maine Securities Division to show that Merrill Lynch's supervision of Galarneau was reasonable.

That submission was made through a letter to the Maine Securities Division dated January 28, 2004, which was circulated twice in draft form by Kandel to Gilbert and Durning. The letter stated that the firm's "review of the Ford account indicates that while it is somewhat active, it was also well diversified between fixed income, equities and cash," and that there were additional features of the portfolio and Ford's investment objectives that supported the manner in which the account was managed. The letter continued, "After Ms. Ford's concerns came to light, however, the Firm learned that Galarneau had exercised time and price discretion on occasion in Ms. Ford's account." The letter explained that because time and price discretion is against company policy, "as well as [other reasons], including management's concerns regarding the activity in Ms. Ford's account, the Firm decided in late December that it was necessary to terminate Ms. Galarneau's employment."

The U-5

On February 6, 2004, nine days after the letter to the Maine Securities Division, Merrill Lynch filed a Uniform Termination Notice for Securities Industry Registration (Form U-5) with the NASD as required by NASD rules whenever a registered stockbroker leaves a firm. In the U-5, Merrill Lynch explained the reason for terminating Galarneau as follows: "Ms. Galarneau was terminated after the firm concluded that she had (l) engaged in inappropriate bond trading in one client's

account and (II) utilized time and price discretion in the accounts of three clients." This was followed by a statement disclosing that Galarneau disagreed with the firm's conclusions.

After Galarneau was terminated, she unsuccessfully tried to find employment as a stockbroker at Smith Barney, Edward Jones, and Morgan Stanley.

Proceedings Below

Galarneau brought an eight-count complaint alleging sex discrimination, breach of contract, breach of fiduciary duty, defamation, tortious interference with economic relations, and violations of the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. § 1001 *et seq.*, and the Equal Pay Act ("EPA"), 29 U.S.C. § 206(d)(1). Galarneau subsequently withdrew the breach of fiduciary duty and EPA claims. After the district court denied Merrill Lynch's motion for summary judgment, the remaining claims proceeded to trial.

At the close of the plaintiff's evidence, Merrill Lynch moved pursuant to Fed. R. Civ. P. 50(a) for judgment as a matter of law on all counts. The district court granted the motion with respect to Galarneau's tortious interference claim, but otherwise denied it. At the close of all evidence, the district court denied Merrill Lynch's renewed motion for judgment as a matter of law. Accordingly, Galarneau's claims for sex discrimination, breach of contract, and defamation were sent to the jury, and her ERISA claim was submitted to the court. The jury rejected Galarneau's discrimination and contract claims, and the court rejected her ERISA claim. The jury found in Galarneau's favor on the defamation claim, awarding Galarneau \$ 850,000 in compensatory damages (of

which \$ 775,000 were for lost wages) and \$ 2,100,000 in punitive damages.

Merrill Lynch again moved for judgment as a matter of law, pursuant to Fed. R. Civ. P. 50(b) or, in the alternative, for a new trial, pursuant to Fed. R. Civ. P. 59(a). The district court denied both motions. Merrill Lynch appeals that decision on the ground that there was insufficient evidence to support the jury's finding of defamation and its award of compensatory damages and punitive damages. It also challenges the district court's exclusion at trial of correspondence between Galarneau and Merrill Lynch regarding the language in the U-5.

II. DISCUSSION

A. The Sufficiency of the Evidence to Support the Defamation Claim

1. Defamation Under Maine Law

[HN1]To prove defamation under Maine law, a plaintiff must establish that the defendant made a false statement that "lower[ed] [her] in the estimation of the community." *Ballard v. Wagner*, 2005 ME 86, 877 A.2d 1083, 1087 (Me. 2005) (quoting *Schoff v. York County*, 2000 ME 205, 761 A.2d 869, 871 (Me. 2000)). Accordingly, "truth is an absolute defense to a charge of defamation." *Garrett v. Tandy Corp.*, 295 F.3d 94, 106 (1st Cir. 2002) (applying Maine law).

[HN2]False statements are defamatory *per se* if they relate to a profession, occupation, or official station in which the plaintiff was employed. See *Saunders v. VanPelt*, 497 A.2d 1121, 1124-25 (Me. 1985). In such cases, malice is implied as a matter of law, and a plaintiff may recover a compensatory award without proving special damages. *Farrell v. Kramer*, 159 Me. 387, 193 A.2d 560, 562 (Me. 1963). *Per se* defamation may not be actionable,

however, if it is privileged. See *Bearce v. Bass*, 88 Me. 521, 34 A. 411, 413 (Me. 1896). "A conditional privilege against liability for defamation arises in settings where society has an interest in promoting free, but not absolutely unfettered speech." *Lester v. Powers*, 596 A.2d 65, 69 (Me. 1991).

The parties agree that Merrill Lynch's statement in the U-5 is conditionally privileged under Maine law. While a conditional (or qualified) privilege does not change the actionable quality of words published, it rebuts the inference of malice that is imputed in the absence of the privilege. See *Saunders*, 497 A.2d at 1124. Where a conditional privilege exists, "liability for defamation attaches only if the person who made the defamatory statements loses the privilege [by] abusing it." *Lester*, 596 A.2d at 69. A conditional privilege may be abused if the defamatory statement is made with reckless disregard as to its falsity. See *Cole v. Chandler*, 2000 ME 104, 752 A.2d 1189, 1194 (Me. 2000).

2. Standard of Review

[HN3]In an appeal from a district court's denial of a motion for judgment as a matter of law, we generally review questions of law *de novo*. *Negron v. Caleb Brett U.S.A., Inc.*, 212 F.3d 666, 668 (1st Cir. 2000). In assessing the sufficiency of the evidence to support a jury verdict, we usually ask "whether, viewing the evidence in the light most favorable to the verdict, a rational jury could have found in favor of the party that prevailed." *Bisbal-Ramos v. City of Mayaguez*, 467 F.3d 16, 22 (1st Cir. 2006). But Merrill Lynch asks us to apply the heightened standard of review appropriate for cases raising First Amendment concerns. See *Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485, 499, 104 S. Ct. 1949, 80 L. Ed. 2d 502 (1984)("In cases raising First Amendment

issues . . . an appellate court has an obligation to 'make an independent examination of the whole record' in order to make sure that 'the judgment does not constitute a forbidden intrusion on the field of free expression.'" (quoting *New York Times Co. v. Sullivan*, 376 U.S. 254, 285, 84 S. Ct. 710, 11 L. Ed. 2d 686 (1964))). We decline to do so, however, because Merrill Lynch failed to argue in the trial court that this case had any First Amendment implications.

In *New York Times v. Sullivan*, the Supreme Court for the first time held that the First Amendment limits the reach of state defamation laws. 376 U.S. at 271. Emphasizing that "freedom of expression upon public questions is secured by the First Amendment," *id.* at 270, the Court held that a public official suing for a libelous publication critical of his official conduct could not recover unless he proved, by clear and convincing evidence, "that the statement was made with 'actual malice' -- that is, with knowledge that it was false or with reckless disregard of whether it was false." *Id.* at 280-81.

Ten years later, the Court again reviewed a defamation case in light of First Amendment considerations in *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 94 S. Ct. 2997, 41 L. Ed. 2d 789 (1974). Noting that the libelous statement at issue was of undoubted public concern, but that, unlike in *New York Times*, the plaintiff was not a public figure, the Court held that the First Amendment protections were reduced. *Id.* at 343-46. Balancing the states' "strong and legitimate . . . interest in compensating private individuals for injury to reputation" against First Amendment concerns, *id.* at 348, the Court held that "so long as they do not impose liability without fault, the States may define for themselves the appropriate standard of liability for a

publisher . . . of falsehood injurious to a private individual," *id.* at 347, but that a state could not allow recovery of presumed damages absent a showing of actual malice. *Id.* at 349-50.

Finally, in *Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc.*, 472 U.S. 749, 759-60, 105 S. Ct. 2939, 86 L. Ed. 2d 593 (1985), [HN4]the Court held that where a private figure is suing over a defamatory statement involving private matters, "the role of the Constitution in regulating state libel law is far more limited." *Id.* at 759. In such cases, a showing of actual malice is not necessary to establish liability or to presume damages. *Id.*

These cases illustrate that questions of whether and to what extent the First Amendment places limits on state defamation law are not without nuance. [HN5]To establish that a particular defamation case raises First Amendment concerns, a defendant must show that the purportedly defamatory statement involved either a public official or a matter of public concern, or both. See *Ramirez v. Rogers*, 540 A.2d 475, 477 (Me. 1988) (finding that First Amendment concerns were not implicated "[b]ecause th[e] case involve[d] a non-media defendant, defaming a private plaintiff concerning a matter that [was] not of public concern"). Only if the defendant succeeds in doing so does the First Amendment impose a special burden on the plaintiff, and even then the specific burden imposed will depend on the circumstances of the case. Once established, it will be the facts underlying that burden that we, as appellate courts, must independently examine to make sure that "the [defamation] judgment does not constitute a forbidden intrusion on the field of free expression." *New York Times*, 376 U.S. at 285; see also *Bose*, 466 U.S. at 508 ("Hence, in *New York Times v.*

Sullivan, after announcing the constitutional requirement for a finding of 'actual malice' in certain types of defamation actions, it was only natural that we should conduct an independent review of the evidence on the dispositive constitutional issue.").

But Merrill Lynch has never argued, except in this court, that the First Amendment places any limit on Maine's defamation laws. It never argued before the district court that Galarneau was a public figure or that the U-5 statement involved a matter of public concern. Indeed, at trial, it never sought to impose on Galarneau the burden of establishing, *by clear and convincing evidence*, that Merrill Lynch had acted with "actual malice" in defaming Galarneau, as required by the First Amendment under the conditions set forth in *New York Times*.⁵ Instead, Merrill Lynch relied unwaveringly on Maine common law to establish that Galarneau had the burden of proving falsity and actual malice by a preponderance of the evidence. Accordingly, the jury was never instructed as to the First Amendment's role in the case, if any.⁶

5 Merrill Lynch did argue that Me. Rev. Stat. Ann. tit. 26, § 598, required Galarneau to establish actual malice by clear and convincing proof. The district court rejected that argument.

6 With respect to the defamation claim, the jury was instructed that

[i]n order to prevail on the claim for defamation regarding the U-5 filing that Merrill Lynch made, Plaintiff must prove, by a preponderance of the evidence, that: . . . the

defendant knew the communication was false or spoke with reckless disregard as to whether the communication was false -- that is, the defendant entertained a high degree of awareness of probable falsity or serious doubt as to the truth of the statement.

As the Maine Supreme Court has noted, [HN6]the burden imposed on plaintiffs by the First Amendment is distinct from that imposed by Maine common law:

Discussion of public officials and public figures on matters of public concern, the U.S. Supreme Court has declared, deserves special favor in a democratic society, and thus such discussion is subject to a conditional privilege -- the "First Amendment privilege" -- that can be overcome only by clear and convincing evidence of knowledge or disregard of falsity. We do not require clear and convincing evidence, however, to overcome a conditional privilege that arises at common law and not from the First Amendment.

Lester, 596 A.2d at 69-70 (internal citations omitted). Because Merrill Lynch failed to make a case for a "First Amendment privilege" at trial, and instead relied exclusively on the conditional privilege afforded by Maine common law, it has forfeited the argument that the First Amendment imposes a special burden on

Galarneau. See *United States v. Slade*, 980 F.2d 27, 30 (1st Cir. 1992) [HN7]("It is a bedrock rule that when a party has not presented an argument to the district court, [it] may not unveil it in the court of appeals."). We therefore have no opportunity to apply heightened review. We review the sufficiency of the evidence supporting the jury's verdict as we would normally, asking whether, viewing the evidence in the light most favorable to the verdict, a rational jury could have found in favor of the party that prevailed. See *Bisbal-Ramos*, 467 F.3d at 22.

On appeal, Merrill Lynch argues that the jury's verdict cannot stand because Galarneau failed to show that its statement was false and malicious, two requirements for liability under Maine's common law of defamation.

3. Falsity

We begin with the question of falsity. At trial, Galarneau argued the statement in the U-5 that she had "engaged in inappropriate bond trading in one client's account" was false. In making this argument, she relied heavily on expert testimony from Gerald Guild, an expert in fixed income securities with forty-five years of experience in the financial services industry. Guild testified that after examining all the relevant documentation (including the Bates report), he concluded that the trading in the Ford account was appropriate and consistent with the investment objectives of the account. He testified that in his opinion, Galarneau's trading in the Ford account was neither excessive nor inappropriate "[b]ecause there was a good and sufficient reason for each and every transaction."

In support of her claim that the statement in the U-5 was false, Galarneau also presented evidence of Merrill Lynch's

recognition and approval of the trading in the Ford account. There was testimony and documentary evidence that during the relevant period -- when the trading in the Ford account was most active -- two of Galarneau's supervisors at Merrill Lynch reviewed and approved the management of the Ford account on at least four separate occasions.⁷ There was also evidence that, in compliance with Merrill Lynch's policy, when the Armor system triggered a fourth review of the activity in the Ford account, Heller sent Ford an "activity letter" on September 10, 2002; Heller drew Ford's attention to a "substantial volume of trading" in her account and, while noting that "active trading involves special risks," never suggested it improper.

7 The jury also heard evidence of other systems of review in place at Merrill Lynch. In a letter to the Maine Securities Division, Merrill Lynch explained:

Merrill Lynch managers reviewed each of the trades in Ms. Ford's account as they occurred. They did so as part of the daily review of the Firm's End-of-Day Reports and 1028 Reports ("1028"), both of which detail all transactions entered in client accounts. The 1028, in addition to listing all daily transactions, provides a synopsis of the client's investment objectives and risk tolerance. (Other information, such as age, net worth, associated accounts, profit and loss,

etc.[]) are also available to the managers through the Firm's computer system.) The 1028 is an important tool in evaluating the suitability of trades entered in client accounts.

In addition, Galarneau introduced two letters Merrill Lynch sent to the Maine Securities Division on July 2 and September 8, 2003, in response to inquiries regarding the Ford complaint, which characterized the Galarneaus' approach to the trading in the Ford account as "prudent" when viewed in the context of the overall market and economic conditions at the time. Galarneau also presented testimony from the authors of these letters, Andrew Kandel and Kathleen Durning, that they always tell the truth when they communicate with state regulators, and that no one ever told the Maine Securities Division that either letter was inaccurate or misleading.

Finally, Galarneau presented evidence that at the time she was terminated, inappropriate bond trading was not one of the reasons Merrill Lynch provided for the termination. She also introduced a letter from Merrill Lynch to the Maine Securities Division dated January 28, 2004 (after her termination), explaining that Galarneau was fired for violating the firm's time and price discretion policy and because of "management's ongoing concerns regarding [t]he activity in Ms. Ford's account," but also describing the account as only "somewhat active," and noting that "[the Ford account] was . . . well diversified between fixed income, equities and cash."

Merrill Lynch argues that Galarneau's evidence is insufficient to support a finding of falsity because:

Guild's conclusory opinion is belied by Galarneau's frequent short-term trading in long-term bonds; the purported "approval" of Galarneau's trading was based largely on Galarneau's own reports and was given before the Bates report revealed the inappropriateness of her trading; although Hocking did not use the term "inappropriate trading," he did tell Galarneau that she was terminated for exercising "very poor judgment in the Ford account by pursuing the complicated strategy" after having been "warned" of "similar conduct in the past;" and Merrill Lynch's letter to Maine regulators specifically noted that Galarneau had been terminated, *inter alia*, as a result of "management's ongoing concerns regarding [t]he activity in Ms. Ford's account."

But these are all arguments that the jury heard and apparently rejected. [HN8]Our task on review is not to weigh the evidence. It is to ask whether, "viewing the evidence in the light most favorable to the verdict," there is sufficient evidence supporting the jury's verdict. *Bisbal-Ramos*, 467 F.3d at 22. We find that there is.

The expert testimony that Galarneau's trading was appropriate, even if active, is strong evidence that Merrill Lynch's statement on the U-5 Form is false. Merrill Lynch disagrees, focusing on the fact that Galarneau and Guild admitted that the trading in the Ford account was "very

active." However, no one contests this fact, mainly because there is no reason to; that trading is "active" does not necessarily mean that it is "inappropriate." This much is clear not only from Guild's testimony, but also from the fact that Merrill Lynch approved of the trading for so long. The very least that may be inferred from the firm's repeated approval of the trading in the Ford account is that there are circumstances in which such activity is warranted. As such, that Galarneau and Guild, along with every other witness to have testified at trial, thought that the trading in the Ford account was active does not answer the question of whether it was inappropriate.

The evidence of Merrill Lynch's continuous approval of Galarneau's trading strategy while the account was at its most active, and its defense of that strategy long after the Ford complaint, also support the jury's ultimate conclusion that the U-5 statement is false. Merrill Lynch again disagrees, relying on the fact that, at the time the firm approved the trading in the Ford account, it did not have the benefit of the Bates report. But the jury was free to disregard this explanation in the face of contradictory evidence presented by Galarneau: First, Galarneau presented evidence about the distortive effect of the report. She testified that the report commingled actual securities losses with securities that were not sold, but declined in market value, counting as a "loss" a security that at the (arbitrary) date of the report may have been down, but later increased in value. Galarneau also pointed out that the report failed to take into account \$ 101,000 in income Ford received and \$ 36,000 in tax savings to Ford, as well as the subsequent \$ 65,000 increase in value of securities retained.

Testimony from Galarneau and Guild, as well as from Richard Heller, that particular trades should be viewed in the context of the overall trading strategy and the market at that time casts further doubt on the importance of the Bates report, which was limited to "when a given security was purchased, the purchase price, when the security was sold, and the sale price." Finally, we are persuaded that the Bates report could not have been the revelation Merrill Lynch claims it was, given that Merrill Lynch defended Galarneau's trading in the Ford account even after the firm received the Bates report in September 2003.

4. Malice Necessary to Overcome Conditional Privilege

Having determined that Galarneau presented sufficient evidence to support a jury finding that the U-5 statement was false, we turn to Galarneau's evidence of malice. As noted above, where a statement is conditionally privileged, "liability for defamation attaches only if the person who made the defamatory statements loses the privilege through abusing it." *Lester*, 596 A.2d at 69. As such, Merrill Lynch will have abused its conditional privilege if it knew the statement it made in the U-5 was false or if it recklessly disregarded its falsity. *Id.*

Much of the evidence that supports a finding of falsity also supports a finding of malice. Evidence that Merrill Lynch approved the trading as it was taking place and defended the trading after it came under attack supports the jury's conclusion that the firm either knew the statement was false, or recklessly disregarded its falsity. See *Rippett v. Bemis*, 672 A.2d 82, 87 (Me. 1996) [HN9] ("Evidence is sufficient to support a finding of reckless disregard for the truth if it establishes that the maker of a statement had 'a high degree of awareness of probable falsity or serious doubt as to

the truth of the statement." (quoting *Onat v. Penobscot Bay Med. Ctr.*, 574 A.2d 872, 874 (Me. 1990)).

Because we find there was sufficient evidence to support the jury's finding of defamation, we affirm the district court's denial of Merrill Lynch's motion for judgment as a matter of law.

B. Evidence of Special Damages

[HN10] In tort law, proof of causation is generally required to sustain an award of special damages.⁸ See generally *Doe v. Chao*, 540 U.S. 614, 621, 124 S. Ct. 1204, 157 L. Ed. 2d 1122 (2004). Accordingly, the district court instructed the jury that Galarneau had to prove that the defamatory statement "play[ed] a substantial part in bringing about or actually causing the injury or damages; and the injury or damages was a direct result, or a reasonably foreseeable consequence of the act."

8 Throughout this opinion we use the term "special damages" in accordance with the common-law definition, i.e., "[g]eneral damages' are compensatory damages for a harm so frequently resulting from the tort that is the basis of the action that the existence of the damages is normally to be anticipated," whereas "[s]pecial damages' are compensatory damages for a harm other than one for which general damages are given." Restatement (Second) of Torts § 904(1) (1979).

Merrill Lynch argues that there was insufficient evidence that Galarneau's lost wages were caused by the defamatory statement in the U-5. Specifically, Merrill Lynch contends that there are other reasons that might explain why Galarneau was not hired by other firms, including the

fact that the U-5 indicated that Galarneau engaged in price and time discretion.

However, we see no reason why Galarneau was required to prove special damages in the first place. [HN11]"The common law of defamation is an oddity of tort law, for it allows recovery of purportedly compensatory damages without evidence of actual loss. Under the traditional rules pertaining to actions for libel, the existence of injury is presumed from the fact of publication." *Gertz*, 418 U.S. at 349. Maine adheres to these traditional rules of defamation law in certain contexts.

[HN12]Under Maine law, defamatory words relating to "profession, occupation or official station" are libelous *per se*. See *Saunders*, 497 A.2d at 1124. "When [defamation] *per se* is established, a plaintiff need not prove special damages or malice in order to recover a substantial award." *Marston v. Newavom*, 629 A.2d 587, 593 (Me. 1993). There can be no doubt that the defamatory statement in the U-5 ("Ms. Galarneau was terminated after the firm concluded that she had . . . engaged in inappropriate bond trading in one client's account") related to Galarneau's profession. As such, she was entitled to recover her lost wages without having to prove causation.⁹ See *Farrell v. Kramer*, 159 Me. 387, 390, 193 A.2d 560 (1963); *Saunders*, 497 A.2d at 1124-25. We therefore affirm the district court's denial of judgment as a matter of law with respect to the award of special damages on the ground Galarneau was entitled to those damages without having to show causation.

9 While recovery of special damages would have been barred were the statement privileged, the jury found that Merrill Lynch lost that

privilege due to its recklessness. *Bemis*, 672 A.2d at 87-88.

C. Punitive Damages

[HN13]Under Maine law, "punitive damages are available based upon tortious conduct only if the defendant acted with malice." *Tuttle v. Raymond*, 494 A.2d 1353, 1361 (Me. 1985). While we have already found that sufficient evidence was presented to establish malice in overcoming the conditional privilege, we must address the issue anew to determine whether the award of punitive damages was appropriate. "Malice" means different things in different contexts. As explained above, a plaintiff may satisfy the malice requirement to overcome a conditional privilege by showing that the defendant either knew the statement published was false or published the statement with reckless disregard as to its falsity. By contrast, to get punitive damages, a plaintiff must show that the defendant acted with actual ill will toward the plaintiff or in a manner "so outrageous that malice toward a person injured as a result of that conduct can be implied." *Tuttle*, 494 A.2d at 1361 (holding that for purposes of punitive damages, "'implied' or 'legal' malice will not be established by the defendant's mere reckless disregard of the circumstances"). Moreover, in the context of punitive damages, the plaintiff has the burden of proving malice by clear and convincing evidence, not by the preponderance of the evidence standard applicable in establishing common law defamation. *Id.* As the Maine Supreme Court has noted,

"[a]lthough malice (in its ordinary sense of ill will or deliberately outrageous misconduct) must be proven by clear and convincing evidence

to support an award of punitive damages, this standard of proof has nothing to do with the 'actual malice' -- that is, knowledge or disregard of falsity -- required to overcome a conditional privilege in defamation."

Lester, 596 A.2d at 70 n.8.

[HN14]We review *de novo* "the legal question of whether the evidence suffices to justify an award [of punitive damages]." *Zimmerman v. Direct Fed. Credit Union*, 262 F.3d 70, 81 (1st Cir. 2001). On appeal, Merrill Lynch argues that the evidence presented at trial was insufficient to support the showing of malice necessary for punitive liability. We agree.

In support of her argument that Merrill Lynch acted maliciously, Galarneau contends that "[t]here can be no question on this record that Merrill Lynch knew that the false accusation in the U-5 would almost certainly result in injury to [her]." But even accepting this as true, [HN15]Maine law requires more where punitive damages are concerned: Merrill Lynch's knowledge must have motivated its statement, or its actions must have been so outrageous as to imply malice. See *Haworth v. Feigon*, 623 A.2d 150, 159 (Me. 1993). There was no evidence that Merrill Lynch made the statement in the U-5 with the intent to deprive Galarneau of a job. And Merrill Lynch's actions in filing the U-5, knowing it "would almost certainly" hinder Galarneau's job prospects, even if established by clear and convincing evidence, is not sufficiently outrageous to warrant punitive damages. See *Veilleux v. Nat'l Broad. Co.*, 206 F.3d 92, 135 (1st Cir. 2000) ("While a jury could find that the alleged misrepresentations were made

knowingly or even recklessly, it could not reasonably infer common-law malice as required under Maine law."); *Staples*, 629 A.2d at 602-04 (finding that employer's conduct in demoting plaintiff and recklessly accusing him of sabotaging computer files after plaintiff criticized employer was insufficient to establish that defendant's conduct was motivated by ill will or so outrageous that malice could be implied); *Boivin v. Jones & Vining, Inc.*, 578 A.2d 187, 188-89 (Me. 1990) (finding that employer's conduct in rehiring employee with promise of employment through retirement, while in fact intending to retain employee only until inventory was reduced, was not so outrageous as to justify award of punitive damages). As such, we find that the evidence presented at trial was insufficient to support an award of punitive damages and therefore reverse the district court's denial of judgment as a matter of law on this point.

D. Evidence Relating to the Drafting of the U-5

Before trial, Galarneau filed a motion in limine to exclude all evidence of communications between Galarneau's counsel and counsel for Merrill Lynch regarding the opportunity to review and comment upon the language Merrill Lynch proposed to use in Galarneau's Form U-5. Galarneau claimed that evidence of such communications was subject to exclusion under Fed. R. Evid. 408 "because it constitutes an offer and/or communication made during settlement negotiations," or, in the alternative, under Rule 403 because it had "minimal relevance compared to its unfair prejudice." The district court granted the motion to exclude, stating:

I'm not going to let it in. I'm not changing my previous ruling. I think under 408, 403,

and in my discretion in this matter, I think it opens doors that might well require counsel to testify. I think they are settlement discussions.

[HN16]"[T]he district court's construction of evidentiary rules is a question of law which we review *de novo*," *United States v. Barone*, 114 F.3d 1284, 1296 (1st Cir. 1989), while the district court's application of the rule to particular facts is reviewed for abuse of discretion, *Blake v. Pellegrino*, 329 F.3d 43, 46 (1st Cir. 2003).

Merrill Lynch argues that the exclusion of this evidence was prejudicial error, and it is therefore entitled to a new trial. We disagree.

[HN17]"Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence." Fed. R. Evid. 403. The trial court employs a balancing test to determine whether Rule 403 applies, weighing the probative worth of the evidence against its potentially confusing effects. See *Fryar v. Curtis*, 485 F.3d 179, 184 (1st Cir. 2007). Thus, even where the evidence may shed light on the disputed issues, the district judge can find the "untoward effects of the proffered evidence" to be so weighty that the evidence should be excluded. *Faigin v. Kelly*, 184 F.3d 67, 80 (1st Cir. 1999).

We "accord district courts considerable latitude in this exercise" and review the exclusion of evidence under Rule 403 for abuse of discretion. *Id.* at 79-80. The district judge enjoys a unique advantage in

observing first-hand the nuances of trial, *Faigin*, 184 F.3d at 80, we therefore give the district court "significant leeway" in making its determinations, *Williams v. Drake*, 146 F.3d 44, 47 (1st Cir. 1998). We have consistently declined to reverse the district court's judgment "from the vista of a cold appellate record" absent "extraordinarily compelling circumstances." *Faigin*, 184 F.3d at 81 (quoting *Freeman v. Package Mach. Co.*, 865 F.2d 1331, 1340 (1st Cir. 1988)); see also *Onujiogu v. United States*, 817 F.2d 3, 6 (1st Cir. 1987) ("Only in compelling circumstances will we reverse the exercise of a district court's informed discretion concerning the relative weight of probative value and unfairly prejudicial effect.").

We find that the district court did not abuse its discretion in excluding the evidence under Rule 403 in this case. As required under the rule, the district court weighed the probative value of the evidence against the risk of confusion of the issues. Finding that the evidence was probative of both parties' contentions with respect to liability and that it would likely require testimony from the attorneys as to the motivations behind the proposed U-5 language and Merrill Lynch's refusal to adopt it, the district court excluded the evidence. *Cf. United States v. Angiulo*, 897 F.2d 1169, 1194 (1st Cir. 1990) (acknowledging the "advocate-witness rule, which generally bars an attorney from appearing as both an advocate and a witness in the same litigation" (internal quotation marks omitted)). We find no fault in this determination. Moreover, Merrill Lynch has not shown, nor has it alleged, any extraordinarily compelling circumstances that would justify our reversal of the district court's ruling. Rather, they have merely alleged that the district judge did not give enough weight to the probative value of the evidence. In light

of the unexceptional nature of Merrill Lynch's allegations, we decline to disturb the district court's ruling under Rule 403.¹⁰

10 Because we find no abuse of discretion in the exclusion of the correspondence under Rule 403, we need not address Merrill Lynch's argument that the evidence was not excludable under Rule 408.

III. Conclusion

For the reasons stated above, we affirm the district court's denial of Merrill Lynch's motion for judgment as a matter of law with respect to (1) the sufficiency of the evidence supporting the jury's finding of defamation and (2) the award of special damages. We also affirm the district court's exclusion of evidence. We reverse, however, the district court's denial of judgment as a matter of law on the punitive damages question and vacate that award.

Affirmed in part; Reversed and Vacated in part. Each party shall bear its own costs.

In the Matter of the Arbitration of Certain Controversies Between UBS Financial Services, Inc. and Karen A. Kurrasch, Petitioners, -and against Marshal D. Gibson and NASD Dispute Resolution, Respondents.

103188/07

SUPREME COURT OF NEW YORK, NEW YORK COUNTY

2007 NY Slip Op 52222U; 2007 N.Y. Misc. LEXIS 7687

November 15, 2007, Decided

NOTICE: THIS OPINION IS UNCORRECTED AND WILL NOT BE PUBLISHED IN THE PRINTED OFFICIAL REPORTS.

CORE TERMS: nasd, expungement, intervene, regulator, confirmation, dealer, arbitration, arbitrator, notice, broker, affirmation, intervenor, database, arbitral, arbitration award, registered, licensing, expunged, confirm, regulatory authorities, public record, legitimate interest, adequately represented, recommendation, registration, compromised, depository, permissive, investor, replies

COUNSEL: Attorneys for Petitioners: Andrew W. Sidman, Esq., Christopher G. Massey, Esq., Bressler, Amery & Ross, P.C., New York, New York.

Attorney for Respondent NASD Dispute Resolution, Inc.: Terri Reicher, Esq., FINRA, Washington, D.C.

Attorneys for Proposed Intervenor-Respondent: R. Verle Johnson, Esq., Philip Moustakis, Esq., Diane Ridley Gatewood, Esq., Office of the Attorney General, New York, New York.

JUDGES: Marcy L. Kahn, J.S.C.

OPINION BY: Marcy L. Kahn

OPINION

Marcy L. Kahn, J.

By notice of petition and petition filed March 29, 2007, UBS Financial Services, Inc. ("UBS") and Karen A. Kurrasch ("Kurrasch") (collectively, "petitioners") commenced this proceeding pursuant to section 7510 of the Civil Practice Law and Rules ("CPLR") and Rule 2130 ("Rule 2130") of the National Association of Securities Dealers, Inc. ("NASD")¹ to confirm an arbitration award in NASD Dispute Resolution Case Number 06-00520 ("the arbitration") rendered by an arbitrator appointed by respondent NASD Dispute Resolution, Inc. ("respondent NASD") on February 6, 2007, after a hearing involving petitioners and

respondent Marshal D. Gibson. The award, *inter alia*, recommended that all reference to the subject matter of the arbitration be expunged from the records on petitioners maintained by the NASD in its Central Registration Depository ("CRD").

1 On July 30, 2007, while this motion was pending, the NASD was merged with the member regulation, enforcement and arbitration operations of the New York Stock Exchange to become the Financial Industry Regulatory Authority ("FINRA"). For purposes of consistence and clarity, in this opinion the court will continue to reference the organization as "NASD."

By notice of motion and affirmation filed April 23, 2007, the Attorney General of the State of New York (the "Attorney General") seeks leave of court to intervene in this proceeding as an intervenor-respondent for the purpose of opposing confirmation of so much of the arbitration award as recommends expungement of records from the CRD. Petitioners UBS and Kurrasch have opposed the Attorney General's motion, arguing that there are no grounds either for its intervention or for vacatur of the award. The Attorney General contends that his office has an interest in the CRD records, that the arbitrators exceeded their authority in granting expungement relief and that the arbitration process and findings were insufficient to support the expungement recommendation. Respondent Marshal D. Gibson has not appeared in this proceeding, and the NASD has not opposed the Attorney General's intervention application.²

2 The court has permitted the Securities Industry and Financial Markets Association ("SIFMA") and the North American Securities Administrators Association, Inc. ("NASAA") to appear in the confirmation proceeding as *amicus curiae*. Neither of the amici has taken any position on the Attorney General's motion seeking intervention.

This court heard oral argument on the intervention issue and on the motion to confirm in this case and another case raising the same issue on August 21, 2007.³ At that time, this court granted the motion to intervene in each case in an oral ruling, but reserved decision on the motions to confirm. This written decision further explains the court's oral ruling granting intervention in this case.

3 The matter was joined for argument on the same issues in *Elizabeth Johnson v. Summit Equities, Inc., Peter O'Neil and NASD, Inc.*, Index No. 104034/07 (NY Co.).

I. BACKGROUND

The CRD system is an electronic database used by NASD, the Securities and Exchange Commission ("SEC"), state securities regulators and others which contains information relating to registration and licensing decisions made by those bodies. (NASD Notice to Members 99-54 [July 1999], attached as Exh. A to the Affirm. of Christopher Massey, Esq., sworn June 13, 2007 ["Massey Affirm."]). The information contained in the system includes criminal histories, disciplinary information, customer complaints, certain arbitration awards, and other information which is submitted by registered broker/dealers and regulatory authorities, and is accessible both to regulators for their official use and to the investing public. (*Id.*). The effectiveness of the centralized national CRD system depends on its containing complete and accurate information. State regulators such as the

Attorney General rely on the CRD in lieu of maintaining their own separate licensing and regulatory record systems.⁴

4 The records are maintained exclusively by electronic means.

Effective in 2004, the SEC approved amendments to NASD Rule 2130, which provides for the expungement from the CRD of certain customer dispute information. Since that time, expungement is limited to cases in which NASD arbitrators make an affirmative finding that certain specified circumstances exist (NASD Rule 2130[b][1])⁵, where they recommend expungement in their arbitral award, and where a court of competent jurisdiction confirms the award. (NASD Rule 2130[a]).

5 That portion of Rule 2130 states in relevant part:

(b)Members or associated persons . . . seeking judicial confirmation of an arbitration award containing expungement relief must name NASD as an additional party . . . unless this requirement is waived . . .

(1)Upon request, NASD may waive the obligation to name NASD as a party if NASD determines that the expungement relief is based on affirmative judicial or arbitral findings that:

(A)the claim, the allegation or information is factually impossible or clearly erroneous;

(B)the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

(C)the claim, allegation, or information is false.

In this case, on February 2, 2006 respondent Gibson filed a statement of claim against petitioners UBS and Kurrasch alleging breach of contract, negligence, failure to supervise, misrepresentation, omission of facts and unsuitability. Petitioners filed a joint answer on April 18, 2006. A contested arbitral evidentiary hearing was held by a single arbitrator on January 24, 2007. On February 6, 2007, the arbitrator issued his award, dismissing Gibson's claims in their entirety. The award also recommended the expungement of all reference to the arbitration from petitioner Kurrasch's registration records maintained in the CRD. (Award, NASD Dispute Resolution Arbitration No. 06-00520 [the "award"], attached as Exh. A to the Verified Petition of UBS and Kurrasch ["petition"]). In conformity with Rule 2130, the arbitrator advised petitioner Kurrasch that she had to obtain confirmation of the award, including the expungement recommendation, by a court of competent jurisdiction before NASD would expunge the information from her record in the CRD.

On March 29, 2007, petitioners commenced the instant proceeding seeking confirmation of the award by this court. Respondent Gibson has not appeared. The Attorney General's motion to intervene followed on April 23, 2007, and was deemed fully submitted for purposes of the instant motion upon oral argument on August 21, 2007.

II. PARTIES' CONTENTIONS

The Attorney General argues that leave to intervene as of right pursuant to CPLR §1012 should be granted, because the data in the records of the CRD belong jointly to the

applicant, NASD and state securities regulators, and because these records are necessary to performance of his statutory duties as New York State's regulator of securities brokers, dealers and their salespersons. He maintains that these duties would be compromised if information concerning registered brokers and dealers were expunged from the depository. He avers that NASD contemplates the intervention of state regulators in judicial confirmation proceedings when a registrant seeks a court order confirming an expungement award.

Petitioners respond that the Attorney General has presented no grounds for vacating the award that fall within the scope of CPLR Article 75. They observe that the arbitrator found Gibson's claims lacked merit and made an affirmative finding as provided by Rule 2130, and that the NASD determined that expungement is appropriate in this case. They argue that the Attorney General cannot prevail on the merits because Rule 2130 preempts any contrary state regulation.

Petitioners further contend that the Attorney General has no right to intervene because the SEC has determined that the State of New York does not have an ownership interest in the records of the CRD. They further maintain that New York State has no legitimate interest which has not been adequately represented through the participation in the drafting of Rule 2130 by NASAA, which represents securities regulators of the fifty states. They argue that the court should deny permissive intervention because the State's claim and the relief sought in this confirmation proceeding lack the commonality required for the granting of intervention under CPLR §1013. They also argue that the court should deny discretionary intervention because it would place an unfair burden on persons seeking expungement, such as petitioners, who have previously obtained the requisite findings and relief needed for expungement in an arbitral award.

The Attorney General replies that its interests are real, are recognized by NASD, and would be compromised if information in the CRD pertaining to dealers licensed in New York were expunged improperly. He maintains that his interest in preserving an accurate and reliable database for his regulatory and licensure purposes, and the investing public's right to complete and accurate information about brokers they may wish to engage, have not been adequately represented in these proceedings. With respect to the argument for permissive intervention under CPLR §1013, the Attorney General states that his claim raises common issues of law and fact with those that the court will be deciding in the underlying proceeding.

III. *DISCUSSION*

A. *Intervention as of Right*

Section 1012 of the CPLR provides in pertinent part:

Intervention as of right. Upon timely motion, any person shall be permitted to intervene in any action:

. . .

2. When the representation of the person's interest by the parties is or may be inadequate and the person is or may be bound by the judgment

(CPLR § 1012[a]).⁶

⁶ Leave of court is required prior to intervention in any special proceeding. (CPLR § 401).

The CRD was established, and its records are maintained, for the benefit of all securities regulators, which include both the NASD, a nationwide self-regulatory organization, the federal government, acting through the SEC, and the regulatory agencies of each individual state. (See § 3.10(a) of the CRD Agreement between the NASD and NASAA, dated January 6 and 8, 1993, as amended November 18, 1997, attached as Exh. 6 to the Affirmation of R. Verle Johnson, Esq., in support, filed April 23, 2007 ["Johnson Affirm."], at P 38). State regulators rely on the data in the CRD to present a complete and accurate record of each broker/dealer firm which can be used in conjunction with, *inter alia*, license renewals or revocations, requests for public inspection and to ascertain the existence of patterns of misconduct warranting regulatory intercession. If information regarding complaints against registered brokers and dealers is expunged from this depository and no longer available to the New York Attorney General, the ability of that office to perform its licensing and regulatory duties and to keep the public informed may be compromised.

Notwithstanding the vigorous protestations to the contrary by petitioners, the agreement establishing the CRD demonstrates that the NASD recognizes that a participating CRD state has a joint property interest in the information contained in the CRD. The CRD agreement between NASD and NASAA provides as follows:

The data on the CRD Uniform Forms filed with the CRD shall be deemed to have been filed with each CRD State in which the applicant seeks to be licensed and with the NASD and shall be the joint property of NASD and these CRD States (and, in the case of Forms BD and BDW, the SEC). The compilation constituting the CRD database as a whole shall be the property of the NASD.

(CRD Agreement, § 3.10[a]). The information in the CRD, therefore, is joint property of the State of New York and the NASD, while the CRD database itself remains the exclusive property of the NASD.

Contrary to petitioners' contention on this motion, the interest of the state regulators in the CRD data maintained by the NASD is not diminished by a comment in the SEC's statement approving Rule 2130. (SEC Order Granting Approval of Proposed Rule Change, Dec. 16, 2003, 68 Fed.Reg. 74667, 74672 [Dec. 24, 2003] ["SEC approval statement"]). In this comment, the SEC rejected the notion that because the CRD system contains data having public record status, its records comprise a privileged class of public record documents necessarily exempt from expungement. While the SEC allowed for expungement of data under certain circumstances, it still acknowledged the "state 'public record' status" of this data. (*Id.*). In other words, while the disposition of documents and data in the CRD is not exclusively determined by the needs of state regulatory authorities such as the Attorney General's Investor Protector Division, and expungement may occur without the consent of state regulators, both NASD and the SEC expressly recognize that such agencies have a legitimate interest in the CRD data and in its disposition. This is the dispositive issue for the instant motion, not whether the Attorney General has an exclusive

ownership interest in the data, or whether he will necessarily prevail on the question of confirmation. The Attorney General clearly has an interest which may be affected by the court's judgment, and which not been adequately represented by any other party, since respondent Gibson, the complainant in the arbitration proceeding, has failed to appear and has not opposed expungement in this case. Moreover, granting or disallowing intervention causes no prejudice to respondent Gibson.

The remaining party, the NASD, which has a dual role as a regulator and as an association constituted of the dealers whom it regulates, has not opposed expungement in this case. In fact, it is in just this situation, where NASD declines to oppose expungement, that the SEC and NASD contemplate intervention by state regulators in court confirmation proceedings. In supporting adoption of the amendments now constituting NASD Rule 2130, the NASD noted that:

states will be able to intervene if they have concerns regarding whether investor protection or regulatory issues have been fairly considered by the NASD.

(SEC approval statement, 68 Fed.Reg. at 74671). The NASD explains that state participation in the court confirmation proceeding:

is an additional safeguard to ensure that courts are aware of the standards of Rule 2130 and relevant regulatory and investor protection interests. . . . The Rule gives NASD and the States the opportunity to participate . . . and make courts fully aware of . . . concerns relating to inappropriate expungements.

(Johnson Affirm., Exh. 10, NASD 2130 Frequently Asked Questions, Question No.9, http://www.nasd.org/RegulatorySystems/CRD/Filing_Guidance/NASDW_005224, now found at <http://www.finra.org/RegulatorySystems/CRD/FilingGuidance/p005224> [last accessed Nov. 1, 2007]). Thus, the drafters of Rule 2130 expressly acknowledged that states have a legitimate interest and should be allowed to intervene in cases of this kind to protect that interest.

Accordingly, since the New York Attorney General has an interest in this proceeding which may not be adequately be represented by the existing parties, the criteria for intervention under CPLR § 1012(a) are met in this case.

B. Intervention by Permission

Section 1013 of the CPLR provides:

[A]ny person may be permitted to intervene in any action . . . when the person's claim or defense and the main action have a common question of law or fact.

The decision to permit intervention under this section rests in the court's sound exercise of discretion, and turns on whether the proceeding and the intervenor's claim have issues in common. Intervention should be liberally allowed, in order to give the intervening party an opportunity to protect its interest. (*Matter of Teleprompter Manhattan CATV Corp. v. State Bd. of Equalization & Assessment*, 34 AD2d 1033 [3rd Dept. 1970]). Where a prospective intervenor has a real or substantial interest in the outcome of the case, it is an abuse of discretion to deny intervention. (*Plantech Housing, Inc. v. Conlan*, 74 AD2d 920, 921 [2nd Dept. 1980]).

If the threshold requirement of a common question of law or fact is met, the court may then exercise its discretion in deciding whether to permit intervention.

(Alexander, Practice Commentaries, McKinney's Cons. Laws of NY, Book 7B [1997], CPLR C1013, at 183.

In *Teichman v. Community Hospital of Western Suffolk*, 87 NY2d 514 (1996), the Court of Appeals stated that in exercising their discretion under this section, trial courts should consider whether the intervenor's claim would be adversely affected without intervention, whether there are common issues of law and fact, and the extent of prejudice to the existing parties if intervention is allowed.

Here, the Attorney General's claim would be adversely affected without intervention, as the data upon which his office relies would be eliminated from the national database used by his office to perform its official regulatory and licensing duties. Further, the Attorney General's claim has in common many questions of law in fact with the confirmation relief sought in this proceeding. These include whether the petitioners are entitled to expungement, the scope of this court's authority to review the arbitral recommendation of expungement, the standard to be employed in such review, and the propriety of expungement of data owned jointly by NASD and the CRD states.

Finally, involvement of the Attorney General in this proceeding will not unduly prejudice the parties. This is not a case where the presence of the intervenor will complicate a lengthy discovery or trial process, as neither discovery nor trial is contemplated in this special proceeding. No substantial rights of any party will be prejudiced: petitioners' award remains in place, and their position will be fully considered on the issue of confirmation, vacation or modification of that award. In sum, the presence of the Attorney General will simply insure that both sides of the novel and complex legal issues are presented in this proceeding. Therefore, the Attorney General should be allowed to intervene on the basis of permissive intervention, as well.

Accordingly, upon the Notice of Petition and Petition of Petitioners UBS and Kurrasch, filed on March 29, 2007; the Notice of Motion and Affirmation of R. Verle Johnson, Esq., filed April 23, 2007, the Memorandum of Law in Support of the Attorney General's Motion to Intervene, filed April 23, 2007; the Affirmation of Christopher Massey, Esq. in Opposition, sworn June 13, 2007; Petitioners UBS and Kurrasch's Memorandum in Opposition, dated June 13, 2007; the Reply Affirmation of R. Verle Johnson, Esq. in Support, sworn June 25, 2007; the Reply Memorandum of Law in Support, dated June 25, 2007; and the oral argument heard on August 21, 2007; it is hereby

ORDERED, that the motion to intervene is granted and that the Attorney General of the State of New York be permitted to intervene in the above-entitled proceeding as an intervenor-respondent; and it is further

ORDERED, that the notice of petition and petition in the above-entitled proceeding be amended by adding the Attorney General of the State of New York as an intervenor-respondent; and it is further

ORDERED, that the attorney for the intervenor shall serve a copy of this order with notice of entry upon the Clerk of the Court and upon the Clerk of the Trial Support Office

(Room 158), who are directed to amend their records to reflect such change in the caption herein.

The foregoing constitutes the decision and order of this court.

ENTER:

Marcy L. Kahn, J.S.C.

Dated: New York, New York

November 15, 2007

[- Return to Page 1-](#)

**IN RE SERIES 7 BROKER QUALIFICATION EXAM SCORING LITIGATION; This
Document Relates To: ALL CASES**

Misc. Action No. 06-355 (JDB);, MDL Docket No. 1772

**UNITED STATES DISTRICT COURT FOR THE DISTRICT OF
COLUMBIA**

510 F. Supp. 2d 35; 2007 U.S. Dist. LEXIS 65920

September 7, 2007, Decided

CASE SUMMARY:

PROCEDURAL POSTURE: In multidistrict litigation, plaintiffs, a putative class of exam takers who incorrectly received failing scores on a broker qualification examination, brought an action for money damages against defendants, the National Association of Securities Dealers (NASD) and its testing contractor. Defendants filed motions to dismiss the action.

OVERVIEW: A mistake was made in the scoring of a broker qualification examination that led a number of individuals to believe erroneously that they had failed when in fact they had obtained a passing score. As a result, they experienced adverse employment consequences including loss of employment, wages, employment benefits, and employment opportunities. The court found that defendants did not satisfy that absolute immunity test. The creation and administration of a standardized competency exam for admission to the securities industry bore little resemblance to the kinds of quasi-judicial functions that typically support absolute immunity.

However, plaintiffs' state-law claims were preempted by the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C.S. § 78o-3(b). The NASD's test existed by virtue of the Exchange Act, to establish a means of ensuring qualified brokers under 15 U.S.C.S. § 78o(b)(7). This duty encompassed the design and administration of the examination as well as the obligation to inform the employers of the scores. There was no express or implied private right of action to enforce § 78o(b)(7).

OUTCOME: The court granted defendants' motions and dismissed each of the underlying actions.

CORE TERMS: immunity, absolute immunity, Exchange Act, exam, common-law, delegated, disciplinary, score, sovereign immunity, discretionary, money damages, immune, private right of action, self-regulatory, oversight, entity, registration, national securities, prosecutorial, ministerial, registered, governmental function, state-law, accorded, dealer, securities industry, qualification, broker-dealer, adjudicatory, membership

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JUDGES: John D. Bates, United States District Judge.

OPINION BY: John D. Bates

OPINION

MEMORANDUM OPINION

This multidistrict litigation is the result of a mistake in the scoring of a broker qualification examination that led a number of individuals to believe erroneously that they had failed when in fact they had obtained a passing score. Plaintiffs have each brought an action for money damages on behalf of a putative class consisting of members who were notified incorrectly that they had failed the exam. Currently before the Court are motions to dismiss filed by defendants National Association of Securities Dealers ("NASD"),¹ a self-regulatory organization ("SRO") under securities laws, and Electronic Data Systems Corporation

("EDS"), a corporation that provided technology services to NASD. The Court concludes that all of plaintiffs' claims, although pled in the form of common-law causes of action, are displaced by the Securities Exchange Act, which envisions Securities and Exchange Commission ("SEC") oversight rather than private damages actions as the sole means of monitoring an SRO's exercise of the regulatory duties that defendants allegedly breached.

1 On July 30, 2007, NASD consolidated its regulatory functions with those of NYSE Regulation, Inc., and changed its name to the Financial Industry Regulatory Authority, Inc. ("FINRA"). Because the events involved in this multidistrict litigation occurred prior to the reorganization, the Court will continue to refer to defendant as NASD.

BACKGROUND

Any individual wishing to buy, sell, or solicit securities products must first take and pass an entry-level examination known as the Series 7. Consol. Class Action Compl. P 12. The computerized exam, which is administered by defendant NASD, consists of approximately 250 multiple choice questions of varying difficulty. *Id.* PP 11, 12. Immediately after an applicant takes the examination, a software program developed by defendant EDS scores the exam and notifies the applicant whether they received a passing score of 70% or above. *Id.* PP 12, 18. Because each examination is composed of a unique set of questions randomly chosen from a larger pool, the "passing score of 70 percent is subject to minor statistical adjustments based on the overall difficulty

of each individual's examination." *Id.* P 24 (quoting NASD news release).

On January 6, 2006, NASD issued a news release acknowledging that a "limited number of individuals" who took the Series 7 exam between October 1, 2004, and December 20, 2005, had been incorrectly notified that they received a failing grade. *Id.* P 23. According to NASD, an error occurred in the process used to weigh the difficulty level of 213 questions that had been introduced to the examination-question pool in October 2004. *Id.* P24. As a result, the scaled scores for those individuals whose examinations included any of the affected questions were incorrectly calculated. *Id.* In all, 1882 tests that should have received a marginally passing score received a marginally failing score instead. *Id.* P 27. The faulty scoring allegedly resulted from human error by an EDS maintenance technician who "inadvertently switched two of the three difficulty variables" when coding the difficulty level of the questions. *Id.* Plaintiffs believe that the coding error was the result of either the use by EDS of outdated software that did not provide a means of verifying the coding, or the failure of EDS to perform quality control. *Id.* P 30. They further allege that NASD failed either to supervise EDS with respect to the coding of exam questions or to ensure that EDS was undertaking adequate quality control measures. *Id.* P 31.

Plaintiffs are members of a putative class that includes individuals who took the Series 7 examination between October 1, 2004, and December 20, 2005, and who were informed immediately after taking the exam that they had failed when, in fact, they had passed. *Id.* P 7. During that time period, plaintiffs notified their sponsoring agencies or member firms that they had failed the Series 7 qualification exam; as a

result, they experienced adverse employment consequences that resulted in "substantial damages." *Id.* P 21. The harm they allegedly suffered included loss of employment, wages, employment benefits, and employment opportunities. *Id.* P 4. Plaintiffs and their sponsoring agencies and member firms were notified by NASD in January 2006 that their failing scores were reported in error and that they had actually passed the Series 7 examination. *Id.* P 22.

The first lawsuit seeking damages for the Series 7 scoring error was filed in the Middle District of Tennessee on February 3, 2006. *See Plunkett v. Nat'l Ass'n of Sec. Dealers, Inc.*, No. 3:06-cv-89 (M.D. Tenn.). Numerous others soon followed in districts across the country. On June 27, 2006, the Judicial Panel on Multidistrict Litigation transferred nine actions to this Court and consolidated them for pretrial purposes as MDL No. 1772, *In re Series 7 Broker Qualification Exam Scoring Litigation*. With the addition of subsequent tag-along cases, this multidistrict litigation now consists of nineteen pending actions. Dismissal has been effected for two other cases that were transferred to this Court after a notice of voluntary dismissal had already been filed in the transferor court. *See Hester v. Nat'l Ass'n of Sec. Dealers*, No. 06-cv-1321 (D.D.C.); *Cutler v. Nat'l Ass'n of Sec. Dealers*, No. 06-cv-1322 (D.D.C.).

Plaintiffs filed a consolidated class complaint on October 31, 2006. The consolidated complaint incorporates all of the parties subject to the MDL proceeding but does not supplant or supersede the complaints filed by plaintiffs in each individual case. *Consol. Class Action Compl.* P 2. For ease of discussion, the Court in this memorandum opinion will refer exclusively to the consolidated class

action complaint. Plaintiffs have asserted four causes of action. First, they claim that NASD breached an implied contract that existed between NASD and plaintiffs by virtue of their taking the Series 7. *Id.* PP 44-48. Second, they allege that EDS breached its contract with NASD, for which plaintiffs claim to be third-party beneficiaries. *Id.* PP 49-53. The third cause of action is asserted against both defendants for negligence in (1) designing, manufacturing, and testing the software used to score the Series 7; (2) failing to properly score the Series 7; (3) failing to properly supervise contractors; and (4) failing to ensure that plaintiffs did not receive incorrect exam results. *Id.* PP 54-57. Finally, plaintiffs assert a negligent-misrepresentation claim against defendants based on the reporting to plaintiffs and their employers that plaintiffs had failed the Series 7. *Id.* PP 58-61. Now pending before the Court are motions to dismiss filed by NASD and EDS. Argument was heard on April 25, 2007. For the reasons provided below, the Court grants defendants' motions and dismisses each of the underlying actions.

STANDARD OF REVIEW

[HN1]All that the Federal Rules of Civil Procedure require of a complaint is that it contain "a short and plain statement of the claim showing that the pleader is entitled to relief,' in order to 'give the defendant fair notice of what the . . . claim is and the grounds upon which it rests.'" *Bell Atl. Corp. v. Twombly*, 550 U.S. , 127 S. Ct. 1955, 1964, 167 L. Ed. 2d 929 (2007) (quoting *Conley v. Gibson*, 355 U.S. 41, 47, 78 S. Ct. 99, 2 L. Ed. 2d 80 (1957)); accord *Erickson v. Pardus*, 551 U.S. , 127 S. Ct. 2197, 2200, 167 L. Ed. 2d 1081 (2007) (per curiam). "A Rule 12(b)(6) motion tests the legal sufficiency of a complaint." *Browning v. Clinton*, 352 U.S.

App. D.C. 4, 292 F.3d 235, 242 (D.C. Cir. 2002). Thus, the complaint's "[f]actual allegations must be enough to raise a right to relief above the speculative level, on the assumption that all the allegations in the complaint are true (even if doubtful in fact)," *Bell Atl. Corp.*, 127 S. Ct. at 1965 (citations omitted), and after drawing all inferences in plaintiffs' favor, *Scheuer v. Rhodes*, 416 U.S. 232, 236, 94 S. Ct. 1683, 40 L. Ed. 2d 90 (1974).

ANALYSIS

Defendants offer a panoply of theories upon which to dismiss plaintiffs' complaints. They primarily urge this Court to find NASD, and by extension EDS, absolutely immune for all acts taken in furtherance of NASD's so-called regulatory functions as a self-regulatory organization ("SRO"). Defendants frame their second theory for dismissal in terms of a lack of a private right of action by plaintiffs to enforce the securities laws and the SEC and NASD rules promulgated thereunder. Third, defendants rely on the liability-release clause in the Form U4, which was signed by all plaintiffs prior to taking the Series 7 exam. Finally, defendants strike at perceived weaknesses on the merits of each claim.

A basic understanding of the role that SROs play in the securities industry is necessary to properly evaluate defendants' arguments. [HN2]NASD is a registered national securities association under the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78o-3(b) (2000), and therefore qualifies as an SRO pursuant to 15 U.S.C. § 78c(a)(26). See *Nat'l Ass'n of Sec. Dealers v. SEC*, 369 U.S. App. D.C. 13, 431 F.3d 803, 804, 806 (D.C. Cir. 2005). As an SRO, NASD "serves as a quasi-governmental agency" in the exercise of its "delegated

government power . . . to enforce . . . the legal requirements laid down in the Exchange Act." *Id.* at 804 (omissions in original) (quoting *Merrill Lynch v. Nat'l Ass'n of Sec. Dealers, Inc.*, 616 F.2d 1363, 1367 (5th Cir. 1980)). The SEC retains close oversight of SROs. For example, the Commission approves of all SRO rule changes, however minor, 15 U.S.C. § 78s(b), and may amend the SRO rules itself if deemed necessary, § 78s(c). If an SRO does not comply with the Exchange Act, the SEC rules, or its own rules, as required by § 78s(g), it faces the suspension or revocation of its SRO registration, as well as other sanctions. § 78s(h).

[HN3]One of NASD's essential functions as a registered national securities association and SRO is to act as a gatekeeper to participation in the securities industry. The Exchange Act requires that practically anyone conducting securities-related business be associated with a broker-dealer that is a member of a registered securities association such as NASD. *Id.* § 78o(a)(1), (b)(8). Furthermore, all natural persons associated with a broker-dealer must "meet such standards of training, experience, competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors." § 78o(b)(7). The SEC has delegated to NASD the task of devising and administering competency exams to individuals who wish to become associated with registered broker-dealers. See *id.*; 17 C.F.R. § 240.15b7-1 (2007) (requiring natural persons associated with registered brokers or dealers to be "registered or approved in accordance with the standards of training, experience, competence, and other qualification standards (including but not limited to . . . passing any required examinations)

established by the rules of any national securities exchange . . . of which such broker or dealer is a member"). [HN4]NASD's own rules specify that an individual must take and pass the General Securities Representative examination, otherwise known as the Series 7, in order to sell, purchase, or induce the sale or purchase of any securities products. NASD Manual, Rules 1031, 1032, *available at* <http://www.finra.org> (last visited Sept. 6, 2007). Furthermore, NASD may bar an individual from becoming associated with a member firm or deny an individual's application for NASD registration if that person does not meet the standards of training, experience, and competence prescribed by NASD's rules. See 15 U.S.C. § 78o-3(g)(3)(B). An individual who is barred from becoming associated with an SRO member firm or denied registration has a right to review of that decision, first by the SEC, *id.* § 78s(d), (f), and then in the federal courts of appeals, see *id.* § 78y.

Defendants seek, apparently for the first time in any court, absolute immunity for NASD's performance of the gatekeeping function just described. SRO absolute immunity was initially recognized only for NASD's exercise of its disciplinary function. See *Austin Mun. Sec., Inc. v. Nat'l Ass'n of Sec. Dealers, Inc.* ("*Austin*"), 757 F.2d 676 (5th Cir. 1985). *Austin* involved constitutional and common-law claims asserted against NASD and officers of a District Business Conduct Committee ("DBCC"), the disciplinary arm of NASD, seeking damages for economic and reputational injuries stemming from disciplinary actions taken against the plaintiffs. *Id.* at 681-82, 684. The Fifth Circuit, observing that it was the first court to consider the "extent of immunity for disciplinary officers of a Congressionally-mandated self-regulatory organization," found that its analysis was "guided . . . by

Supreme Court decisions concerning the immunity of judges, prosecutors, and executive disciplinary officials." *Id.* at 686. Those decisions recognized an absolute-immunity defense for government officials "whose special functions or constitutional status requires complete protection from suit." *Harlow v. Fitzgerald*, 457 U.S. 800, 807, 102 S. Ct. 2727, 73 L. Ed. 2d 396 (1982). The Fifth Circuit noted that lower courts had extended absolute immunity to private individuals performing similar functions. See *Austin*, 757 F.2d at 690-91 (citing, inter alia, *Simons v. Bellinger*, 207 U.S. App. D.C. 24, 643 F.2d 774, 785 (D.C. Cir. 1980) (bar association disciplinary committee members), and *Corey v. N.Y. Stock Exch.*, 691 F.2d 1205, 1208-11 (6th Cir. 1982) (arbitrators)).

The *Austin* court thus proceeded to analyze the claims against the NASD defendants under the requirements drawn from the Supreme Court's decision in *Butz v. Economou*, 438 U.S. 478, 510-13, 98 S. Ct. 2894, 57 L. Ed. 2d 895 (1978) (finding officials of Department of Agriculture absolutely immune from suits for money damages based on alleged violations of constitutional rights). See *Austin*, 757 F.2d at 688, 689. Under the Fifth Circuit's interpretation of *Butz*, [HN5]if:

- a) the official's functions share the characteristics of the judicial process;
- b) the official's activities are likely to result in recriminatory lawsuits by disappointed parties; and
- c) sufficient safeguards exist in the regulatory framework to control unconstitutional conduct,

then that person's official conduct is absolutely immune from civil liability.

Id. at 688; accord *Simons*, 643 F.2d at 778. Applying these factors first to the DBCC members, the court concluded that they were absolutely immune for actions within the scope of their disciplinary duties, which were essentially adjudicatory and prosecutorial in nature. *Austin*, 757 F.2d at 689-91. The court then applied *Butz* to NASD itself, and found that NASD too "was acting in an adjudicatory and prosecutorial capacity" because it was being sued solely on the basis of the DBCC members' conduct. *Id.* at 692. The court also concluded that NASD would be a target for recriminatory lawsuits and that sufficient safeguards against unconstitutional conduct existed in the regulatory framework, which provided for SEC, congressional, and judicial oversight of disciplinary actions. *Id.* Thus, NASD was absolutely immune from civil liability. *Id.* at 692.

Other courts, finding *Austin* persuasive, have borrowed official-immunity principles to confer absolute immunity on SROs for suits arising out of their disciplinary activities. The Second Circuit, following *Austin*, has held that the New York Stock Exchange ("NYSE") "is absolutely immune from damages claims arising out of the performance of its federally-mandated conduct of disciplinary proceedings." *Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 58 (2d Cir. 1996). Like the Fifth Circuit, the Second Circuit observed that absolute immunity had previously been extended to "private entities engaged in quasi-public adjudicatory and prosecutorial duties," *id.* at 58, and applied the *Butz* factors to the NYSE to the same effect, *id.* at 59.

Similarly, a judge of this Court found NASD and its disciplinary officials absolutely immune from liability for prosecutorial and adjudicative acts. *Zandford v. Nat'l Ass'n of Sec. Dealers, Inc.*, 30 F. Supp. 2d 1, 18 (D.D.C. 1998). That decision was issued on remand after the D.C. Circuit, in a non-precedential opinion, stated its "concern[] that the doctrine of absolute immunity might have been applied [in the district court's earlier opinion] with too broad a stroke." *Zandford v. Nat'l Ass'n of Sec. Dealers, Inc.*, 317 U.S. App. D.C. 83, 80 F.3d 559 1996 WL 135716, at *1 (D.C. Cir. 1996); see *id.* ("While the NASD and DBCC disciplinary officers are entitled to absolute immunity for actions that are prosecutorial or adjudicative in nature, see *Austin Municipal Securities, Inc. v. NASD, Inc.*, 757 F.2d 676 (5th Cir. 1985), absolute immunity does not extend to acts that are purely investigatory or administrative."). The D.C. Circuit eventually affirmed *Zandford* on statute-of-limitations grounds, see *Zandford v. Nat'l Ass'n of Sec. Dealers, Inc.*, 343 U.S. App. D.C. 52, 221 F.3d 197, 2000 WL 292931 (D.C. Cir. Feb. 16, 2000), and thus has not addressed SRO immunity in a published opinion.

Here, plaintiffs argue that NASD's and EDS's activities would not qualify under the *Butz* factors for the type of official immunity applied to SROs in *Austin* and *Barbara*. The Court agrees that defendants do not satisfy that absolute immunity test. NASD half-heartedly evokes the "close parallels between NASD's power to investigate and expel individuals and its delegated authority to examine and admit individuals" as a basis for absolute immunity under the *Butz* analysis. NASD's Mem. in Support of Mot. to Dismiss ("NASD's Mem.") at 15 n.6. Yet the creation and administration of a standardized competency exam for admission to the securities industry (to use

a description of events urged by NASD) bears little resemblance to the kinds of quasi-judicial functions that typically support absolute immunity. See, e.g., *Antoine v. Byers & Anderson, Inc.*, 508 U.S. 429, 435-36, 113 S. Ct. 2167, 124 L. Ed. 2d 391 (1993) (explaining that [HN6]"touchstone" of judicial immunity doctrine "has been performance of the function of resolving disputes between parties, or of authoritatively adjudicating private rights" (internal quotation marks omitted)). The judicial activity that is perhaps the closest analog--"the inherent judicial function of determining who is authorized to practice law," *Simons*, 643 F.3d at 780--warrants absolute immunity only because it is a function "so inherently related to the essential functioning of the courts as to be traditionally regarded as [a] judicial act[]." *Sparks v. Character & Fitness Comm. of Ky.*, 859 F.2d 428, 434 (6th Cir. 1988). Although NASD's creation of the Series 7 and its denial of plaintiffs' registration based on their apparent failure of that exam is factually similar to a bar admission committee's administration of the bar exam and the denial of a bar application based on a failing exam score, the latter function is deemed to be judicial for unique functional and historical reasons. See *Sparks*, 859 F.2d at 434. As noted, however, NASD does not press this analogy. Instead, it contends that the parallels between its actions here and its power to investigate and expel members "are not necessary to the analysis" because "the test is whether NASD was exercising a 'regulatory' function 'consistent with' its role under the Exchange Act and SEC regulations." NASD's Mem. at 15 n.6.

The recent trend has indeed been to extend SRO absolute immunity to encompass so-called regulatory acts. The move away from official-immunity doctrines and towards the concept of regulatory

immunity was presaged by the Second Circuit's decision in *Barbara*. Although the grant of absolute immunity to the NYSE was based on the application of traditional official-immunity principles, i.e., the *Butz* factors, the court additionally observed that "absolute immunity is particularly appropriate in the unique context of the self-regulation of the national securities exchanges." *Barbara*, 99 F.3d at 59. The court continued:

Under the Exchange Act, the Exchange performs a variety of regulatory functions that would, in other circumstances, be performed by a government agency. Yet government agencies, including the SEC, would be entitled to sovereign immunity from all suits for money damages. See *Sprecher v. Graber*, 716 F.2d 968, 973 (2d Cir. 1983); see also *Austin*, 757 F.2d at 692. As a private corporation, the Exchange does not share in the SEC's sovereign immunity, but its special status and connection to the SEC influences our decision to recognize an absolute immunity from suits for money damages with respect to the Exchange's conduct of disciplinary proceedings.

Id.

Building on this dictum, the Ninth Circuit conclusively adopted regulatory immunity in *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159 F.3d 1209 (9th Cir. 1998). *Sparta* involved common-law claims brought against NASD for its decision to suspend trading of, and to delist temporarily, the plaintiff's stock offering. *Id.*

at 1212. Those decisions were not deemed adjudicatory, prosecutorial, or arbitral acts. Nonetheless, the Ninth Circuit believed that "[e]xtending absolute immunity when a self-regulatory organization is exercising *quasi-governmental* powers is consistent with the structure of the securities market as constructed by Congress," *id.* at 1213 (emphasis added)--a structure that grants SROs "enormous discretionary authority concerning stock listing and de-listing," but subject to close SEC oversight, *id.* at 1214. The Ninth Circuit quoted the Second Circuit's observations in *Barbara* regarding SEC sovereign immunity and concluded that self-regulatory organizations enjoy immunity from suits "when they are acting under the aegis of the Exchange Act's delegated authority." *Id.*

Subsequent to *Sparta*, the Second Circuit reevaluated the meaning of its own decision in *Barbara* and, like the Ninth Circuit, concluded that an SRO is absolutely immune "from liability for claims arising out of the discharge of its duties under the Exchange Act." *D'Alessio v. N.Y. Stock Exch., Inc.*, 258 F.3d 93, 104 (2d Cir. 2001). Although acknowledging that "the immunity inquiry in *Barbara* was confined to the NYSE's conduct in connection with disciplinary proceedings," the Second Circuit in *D'Alessio* stated that "*Barbara* stood for the broader proposition that [HN7]a SRO, such as the NYSE, may be entitled to immunity from suit for conduct falling within the scope of the SRO's regulatory and general oversight functions." *Id.* at 105. Such immunity is appropriate, the Second Circuit has reasoned, because "SROs effectively 'stand[] in the shoes of the SEC'" when "they perform regulatory functions that would otherwise be performed by the SEC." *DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 (2d Cir. 2005) (alteration in original) (quoting

D'Alessio, 258 F.3d at 105)). And, because an SRO "performs a variety of regulatory functions that would, in other circumstances, be performed by [the SEC]"--an agency which is accorded sovereign immunity from all suits for money damages--[an SRO] should, in light of its 'special status and connection to the SEC,' out of fairness be accorded full immunity from suits for money damages, as well." *Id.* at 97 (first alteration in original) (quoting *Barbara*, 99 F.3d at 59); see also *D'Alessio*, 258 F.3d at 105 ("It follows that the NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC's broad oversight authority.").

The Second Circuit has taken the further step of according absolute immunity to private entities that exercise regulatory functions pursuant to a delegation of authority from an SRO. Reasoning that "the decision to extend absolute immunity depends 'upon the nature of the governmental function being performed,'" rather than the identity of the person or entity performing the function, the court found the for-profit Nasdaq absolutely immune for its performance of "regulatory duties delegated to it by the NASD." *DL Capital Group, LLC*, 409 F.3d at 99 n.4 (quoting *D'Alessio*, 258 F.3d at 104-05).

The Second and Ninth Circuits remain the only two courts of appeals to have afforded absolute immunity to SROs based on the exercise of regulatory functions. The Eleventh Circuit did, however, recently hold argument en banc to consider whether NASD and its subsidiary Nasdaq enjoy absolute immunity for their advertising and marketing activities. See *Weissman v. Nat'l Ass'n of Sec. Dealers, Inc.*, No. 04-13575, Order (11th Cir. Mar. 8, 2007). In the now-vacated panel opinion in *Weissman*, all three judges agreed that SROs should be

accorded "absolute immunity from civil damages for conduct undertaken as part of their statutorily delegated adjudicatory, regulatory, and prosecutorial authority," and disagreed only as to whether the alleged activities were regulatory in nature.

² *Weissman v. Nat'l Ass'n of Sec. Dealers, Inc.*, 468 F.3d 1306, 1311 (11th Cir. 2006), vacated pending rehearing en banc, 481 F.3d 1295, 1296 (11th Cir. 2007); *id.* at 1315 (Tjoflat, J., dissenting) ("NASD and NASDAQ enjoy absolute immunity from suit when 'acting under the aegis of the Exchange Act's delegated authority.'" (quoting *Sparta Surgical Corp.*, 159 F.3d at 1214)). All three members of the initial panel also adopted the rationale that "NASD 'stands in the shoes' of the SEC, and thus is 'entitled to the same immunity enjoyed by the SEC when [NASD] is performing functions delegated to it under the SEC's broad oversight authority.'" *Id.* at 1316 (Tjoflat, J., dissenting) (quoting *D'Alessio*, 258 F.3d at 105); see also *id.* at 1311. Additionally, at least one other district court outside of the Second and Ninth Circuits has applied regulatory immunity to an SRO based exclusively on this reasoning. See *In re Olick*, No. 99-cv-5128, 2000 U.S. Dist. LEXIS 4275, 2000 WL 354191, at *4 (E.D. Pa. Apr. 4, 2000).

2 The difficulty the Eleventh Circuit has encountered in answering this question is in some ways reminiscent of "the 'non-governmental'-'governmental' quagmire that . . . long plagued the law of municipal corporations." *Indian Towing Co. v. United States*, 350 U.S. 61, 65, 76 S. Ct. 122, 100 L. Ed. 48 (1955).

As the progression of the law in this area indicates, [HN8]courts have looked to the sovereign immunity of the SEC as a justification for extending absolute immunity to SROs. Although the SROs in

these cases have been granted immunity coextensive with that of the SEC,³ it is not necessarily true that a plaintiff alleging a tort or contract claim based on actions taken by the SEC would have no recourse against the United States more generally. The federal government's entitlement to sovereign immunity inures only so long as it has not been waived, and whether a plaintiff could recover money damages based on the particular claims alleged would seem to require a case-by-case consideration of the various statutes waiving sovereign immunity. Such an analysis is not always straightforward. In supplemental briefing requested by this Court, the parties disagreed as to whether plaintiffs here could have asserted claims under the FTCA or the Tucker Act, assuming hypothetically that the alleged actions with respect to the Series 7 had been taken by the SEC itself instead of an SRO and its contractor. With respect to the tort claims, this analysis implicates, among other things, the FTCA's discretionary-function exception, under which the United States retains its immunity against suits premised on the exercise of discretion by its officers. See 28 U.S.C. § 2680(a) (2000). Thus far, however, courts applying regulatory immunity to SROs have found it unnecessary to look beyond the immunity of the SEC as an agency. The result of this approach, criticized by plaintiffs, is that an SRO may actually enjoy greater immunity than would the government if a federal official had performed the regulatory function. See Pls.' Opp'n to Defs.' Mot. to Dismiss ("Pls.' Opp'n") at 12-13.

3 The SRO immunity cases have all cribbed the general proposition that the government has not waived the SEC's immunity from suits for money damages from the Second Circuit's opinion in *Sprecher v. Graber*. See,

e.g., *Sparta*, 159 F.3d at 1214 (citing *Sprecher*, 716 F.2d at 973). In *Sprecher*, the court observed that [HN9]the Federal Tort Claims Act ("FTCA"), 28 U.S.C. § 1346(b) (1976), provided no basis for the plaintiff's claims against the SEC "since it authorizes suits only against the United States itself, not its individual agencies"; the Tucker Act, 28 U.S.C. § 1346(a) (1976), provided no jurisdiction for the action in the district court because the amount in controversy exceeded \$10,000; and the Administrative Procedure Act, 5 U.S.C. § 702 (1976), does not waive sovereign immunity for claims seeking money damages. 716 F.2d at 973.

Plaintiffs also object to what they see as the unfairness of courts on the one hand affording absolute immunity to SROs based on their quasi-governmental status while on the other hand refusing to recognize SROs as state actors. See, e.g., *Scher v. Nat'l Ass'n of Sec. Dealers, Inc.*, 386 F. Supp. 2d 402, 408 (S.D.N.Y. 2005). Plaintiffs frame their argument in terms of [HN10]judicial estoppel, which "prohibit[s] parties from deliberately changing positions according to the exigencies of the moment." *New Hampshire v. Maine*, 532 U.S. 742, 750, 121 S. Ct. 1808, 149 L. Ed. 2d 968 (2001) (internal quotation marks omitted). Although that doctrine is not satisfied in this case,⁴ there is at the very least a superficial appeal to plaintiffs' argument: why should an entity afforded absolute immunity as an extension of the "sovereign immunity which governmental agencies enjoy," *Weissman*, 468 F.3d at 1311, *vacated*, 481 F.3d 1295, not be held accountable for constitutional violations in the same manner as those governmental agencies? Again, the result of a sovereign-immunity based rationale may be that an

SRO enjoys greater protection from suit than would the government.

4 Before NASD could be precluded by judicial estoppel from claiming absolute immunity here, this Court would first have to find that NASD's position is "clearly inconsistent" with its position in previous proceedings that it is not a state actor, and then consider whether NASD "has succeeded in persuading a court to accept that . . . earlier position." *New Hampshire*, 532 U.S. at 750; see also *id.* at 750-51 ([HN11]"Absent success in a prior proceeding, a party's later inconsistent position introduces no 'risk of inconsistent court determinations,' and thus poses little threat to judicial integrity." (citation omitted)). [HN12]The state-actor doctrine is activity specific. It requires "such a 'close nexus between the State and the challenged action' that seemingly private behavior 'may be fairly treated as that of the State itself.'" *Perpetual Sec., Inc. v. Tang*, 290 F.3d 132, 137 (2d Cir. 2002) (quoting *Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n*, 531 U.S. 288, 295, 121 S. Ct. 924, 148 L. Ed. 2d 807 (2001)). Plaintiffs point to a brief submitted by NASD to the D.C. Circuit in which it argued that decisions about membership admission and rejection did not "take[] on the quality of government action." Reply Brief for Petitioner at 10, *Nat'l Ass'n of Sec. Dealers, Inc. v. SEC*, 431 F.3d 803, 369 U.S. App. D.C. 13 (D.C. Cir. 2005) (No. 05-1154). But even assuming that this position is clearly inconsistent with NASD's current one, the D.C. Circuit did not adopt NASD's approach. In fact, plaintiffs have not cited *any* case

in which a court accepted an argument by NASD that it is not a state actor with respect to the type of action challenged in this case.

Moreover, the approach taken in SRO cases appears to differ from that used in other contexts where absolute immunity has been extended to private actors or entities exercising federally delegated governmental functions. The concept of providing absolute immunity to certain non-governmental actors is not unique to SROs. As the Fourth Circuit has explained, [HN13]"[i]f absolute immunity protects a particular governmental function, no matter how many times or to what level that function is delegated, it is a small step to protect that function when delegated to private contractors, particularly in light of the government's unquestioned need to delegate governmental functions." *Mangold v. Analytic Servs., Inc.*, 77 F.3d 1442, 1447-48 (4th Cir. 1996); cf. *Boyle v. United Tech. Corp.*, 487 U.S. 500, 511, 108 S. Ct. 2510, 101 L. Ed. 2d 442 (1988). But rather than looking to the sovereign immunity of the federal agency whose officials would otherwise have been tasked with a particular function,⁵ courts in non-SRO cases have applied the common law of immunity for federal officials articulated in *Westfall v. Erwin*, 484 U.S. 292, 295, 108 S. Ct. 580, 98 L. Ed. 2d 619 (1988). In *Westfall*, the Supreme Court recognized absolute immunity from state-law tort suits for federal officials who were exercising discretion while acting within the scope of their official duties, so long as the public benefits derived from the grant of immunity outweigh the costs. *Id.* at 295-98 & n.3. Although *Westfall* was superseded by the Federal Employees Liability Reform and Tort Compensation Act, see 28 U.S.C. § 2679(d), the "*Westfall* test remains the framework for determining when non-governmental persons or entities are

entitled to the same immunity." *Murray v. Northrup Grumman Info. Tech., Inc.*, 444 F.3d 169, 174 (2d Cir. 2006); accord *Houston Cmty. Hosp. v. Blue Cross & Blue Shield of Tex., Inc.*, 481 F.3d 265, 269 (5th Cir. 2007); *Mangold*, 77 F.3d at 1447 & n.4; see also *Beebe v. Wash. Metro. Area Transit Auth.*, 327 U.S. App. D.C. 171, 129 F.3d 1283, 1289 (D.C. Cir. 1997) (noting that "*Westfall* remains the common law rule" for official immunity).

5 The borrowing of "sovereign" immunity by private entities exercising governmental functions is not wholly unprecedented. At common law, a municipal corporation "was an arm of the State, and when acting in that 'governmental' or 'public' capacity, it shared the immunity traditionally accorded the sovereign." *Owen v. City of Independence, Missouri*, 445 U.S. 622, 645, 100 S. Ct. 1398, 63 L. Ed. 2d 673 (1980). "But the principle of sovereign immunity--itself a somewhat arid fountainhead for municipal immunity--is necessarily nullified when the State expressly or impliedly allows itself, or its creation, to be sued." *Id.* (footnote omitted). Furthermore, this Circuit long ago rejected the sovereign-immunity approach to municipal liability in favor of a discretionary/ministerial analysis. See *Spencer v. Gen. Hosp. of Dist. of Columbia*, 138 U.S. App. D.C. 48, 425 F.2d 479, 481 (D.C. Cir. 1969) ("We found that the articulation of the immunity test in terms of 'governmental,' as opposed to 'proprietary,' functions had increasingly lost its vitality as an accurate or adequate rationale for the immunity privilege."). The Supreme Court has characterized this latter

analysis as "grounded not on the principle of sovereign immunity, but on a concern for separation of powers." *Owen*, 445 U.S. at 648.

[HN14]Whether considered under this *Westfall*-based line of precedent or the analysis in the SRO regulatory-immunity cases, an SRO would be immunized from suits arising out of the exercise of a *discretionary* regulatory function. The results may diverge, however, when the challenged action is ministerial in nature--a label that plaintiffs seek to apply to defendants' actions here. The Supreme Court has been "quite sparing in [its] recognition of absolute immunity, and [has] refused to extend it any further than its justification would warrant." *Antoine*, 508 U.S. at 432 n.4 (quoting *Burns v. Reed*, 500 U.S. 478, 486-87, 111 S. Ct. 1934, 114 L. Ed. 2d 547 (1991)). Thus, in *Westfall*, the Court rejected the view that absolute immunity should apply to all conduct falling within the scope of an official's duties because "[t]he central purpose of official immunity, promoting effective government, would not be furthered by shielding an official from state-law tort liability without regard to whether the alleged tortious conduct is discretionary in nature." *Westfall*, 484 U.S. at 296; cf. *Berkovitz v. United States*, 486 U.S. 531, 538, 108 S. Ct. 1954, 100 L. Ed. 2d 531 (1988) ("[W]e intend specifically to reject the Government's argument . . . that the [discretionary-function] exception precludes liability for any and all acts arising out of the regulatory programs of federal agencies."). Lower courts applying governmental immunity to private entities likewise have been careful to do so "only when 'the contributions of immunity to effective government . . . outweigh the . . . harm to individual citizens.'" *Murray*, 444 F.3d at 175 (quoting *Doe v. McMillan*, 412 U.S. 306, 320, 93 S. Ct. 2018, 36 L. Ed. 2d

912 (1973)). As part of this analysis, they too require that the alleged actions be discretionary in nature. See, e.g., *Houston Cmty. Hosp.*, 481 F.3d at 269; *Murray*, 444 F.3d at 175; *Mangold*, 77 F.3d at 1447.

Defendants suggest, however, that courts granting regulatory immunity to SROs have not distinguished between discretionary and ministerial actions, and instead have accorded immunity so long as the SRO's actions were consistent with the Exchange Act. See, e.g., NASD's Reply in Support of Mot. to Dismiss at 3-4. But, except for one district court case in which an SRO was explicitly accorded immunity for actions "ministerial in nature"--the court there believed that "[i]t would be illogical to clothe the NASD with absolute immunity for its regulatory decisions, and then to impose liability on a clearing agent that simply carried out its functions in obedience to, and in express reliance on, those decisions," *Dexter v. Depository Trust & Clearing Corp.*, 406 F. Supp. 2d 260, 264 (S.D.N.Y. 2005)--the decisions in the SRO regulatory context have not addressed the discretionary/ministerial distinction one way or the other. To the extent that it is possible to characterize post-hoc the actions taken by the SROs in those cases, they resemble exercises of discretion. See *DL Capital Group*, 409 F.3d at 96 (cancelling trades); *D'Alessio*, 258 F.3d at 106 (interpreting and enforcing Exchange Act rules and regulations); *Sparta*, 159 F.3d at 1211 (delisting securities and suspending trading). Finally, the Court does not see the need to address in detail certain decisions relied upon by defendants because they involve arbitral or judicial immunity and are thus inapposite. See, e.g., *New Eng. Cleaning Servs., Inc. v. Am. Arbitration Ass'n*, 199 F.3d 542, 545 (1st Cir. 1999); *Sindram v. Suda*, 300 U.S. App. D.C. 110, 986 F.2d 1459, 1461 (D.C. Cir. 1993); *Austern v.*

Chi. Bd. Options Exch., Inc., 898 F.2d 882, 886 (2d Cir. 1990).

Defendants argue that if the discretionary/ministerial distinction does apply to SROs (and it is difficult to see why it should not), their actions fall on the discretionary side of the line. [HN15]It is not the case that all "governmental activities involving an element of choice" are entitled to immunity. *United States v. Gaubert*, 499 U.S. 315, 335, 111 S. Ct. 1267, 113 L. Ed. 2d 335 (1991) (Scalia, J., concurring). "Because the purpose of the [discretionary-function] exception is to prevent judicial 'second-guessing' of legislative and administrative decisions grounded in social, economic, and political policy through the medium of an action in tort, when properly construed, the exception protects only governmental actions and decisions based on considerations of public policy." *Id.* at 323 (internal quotation marks and citation omitted). This definition of "discretionary" is more likely satisfied with respect to NASD, which is alleged to have negligently supervised EDS's activities, than with respect to EDS, which allegedly negligently carried out the technological aspects of the Series 7 administration. See *Burkhart v. Wash. Metro. Area Transit Auth.*, 324 U.S. App. D.C. 241, 112 F.3d 1207, 1217 (D.C. Cir 1997) (finding supervision of transit employees a discretionary act). In any event, however, this Court need not decide conclusively whether the alleged activities in this case were discretionary or ministerial in nature because it finds that plaintiffs' claims are subject to dismissal on another rationale.

There is a thread of reasoning running through the SRO regulatory immunity cases that doctrinally sounds more in preemption than immunity, and which this Court finds persuasive. [HN16]Preemption

derives from the understanding that Congress's carefully crafted design for regulation of the securities industry, which depends upon the SEC's delegation of governmental functions to private SROs, leaves no room for plaintiffs to use common-law claims to recover damages for an SRO's negligent performance of its regulatory duties. For example, the Ninth Circuit noted in *Sparta* that permitting the plaintiff's common-law breach of contract suit against NASD to proceed based on an implied contract between NASD and an applicant "would allow states to define by common law the regulatory duties of a self-regulatory organization, a result which cannot co-exist with the Congressional scheme of delegated regulatory authority under the Exchange Act." *Sparta Surgical Corp.*, 159 F.3d at 1215; see also *id.* at 1213-14 (describing structure of securities market). The Second Circuit similarly observed in *Barbara* that "allowing suits against the Exchange arising out of the Exchange's disciplinary functions would clearly 'stand[] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress,' namely, to encourage forceful self-regulation of the securities industry." 99 F.3d at 59 (citations omitted) (alteration in original). Although that court did not squarely rely "on the doctrine of federal preemption" in that case, it cited the doctrine in further support of its holding that the SRO was immune from common-law damages claims. *Id.*

Defendants rely on what they call [HN17]a private-right-of-action analysis, referring to cases in which courts have precluded common-law claims arising out of an SRO's performance of its delegated regulatory functions. This analysis, too, sounds in preemption, insofar as the Exchange Act displaces common-law actions that seek damages arising from the

breach of an SRO's Exchange Act duties.⁶ The cases cited by defendants begin with the premise that the Exchange Act does not itself provide a private right of action, either express or implied, for enforcement of the various regulatory duties delegated to SROs. For example, it is well-established that no private right of action exists with respect to the Exchange Act's requirement, found in 15 U.S.C. § 78s(g), that SROs comply with the Act and their own rules. See, e.g., *MM&S Fin., Inc. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 364 F.3d 908, 911 (8th Cir. 2004); *Feins v. Am. Stock Exch., Inc.*, 81 F.3d 1215, 1224 (2d Cir. 1996); see also *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 681 (9th Cir. 1980) (finding "no implied right of action for an NASD rule violation"). The Second Circuit has also declined to imply a private right of action under the Exchange Act for damages based on the wrongful denial of SRO membership. *Feins*, 81 F.3d at 1223.

6 Analogous concerns surface with respect to a predicate question in many SRO cases--whether, in the removal context, the plaintiff's common-law claims implicate substantial federal interests sufficient to support federal-court jurisdiction. See, e.g., *D'Alessio*, 258 F.3d at 102 & n.6 (asserting jurisdiction and noting that breach-of-contract and negligent-misrepresentation claims were "predicated on alleged breaches of certain duties imposed on the NYSE under the Exchange Act in its capacity as a SRO"); *Sparta Surgical Corp.*, 159 F.3d at 1212 (finding federal jurisdiction over state-law claims because "viability of any cause of action founded upon NASD's conduct in delisting a stock or suspending trading depends on whether the association's rules were

violated"); *Lowe v. NASD Regulation, Inc.*, No. 99-cv-1751, 1999 U.S. Dist. LEXIS 19489, 1999 WL 1680653, at *3 (D.D.C. 1999) ("Although the Plaintiffs['] complaint is careful to allege only state law claims, each claim is predicated on the NASDR's violation of its own rules. Without explicitly pleading so, the Plaintiffs are seeking to enforce the duty to follow its own Rules of Arbitration, which is a duty imposed by the Exchange Act.").

Building upon these holdings, courts have logically concluded that [HN18]the Exchange Act preempts common-law claims that are nothing more than disguised actions to enforce regulatory duties. In *Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc.*, 191 F.3d 198 (2d Cir. 1999), state-law tort claims were asserted against NASD for damages resulting from the revocation of the plaintiff's offer of employment after NASD denied her registration application. *Id.* at 200. Upon acknowledging *Feins*'s holding that "there is no private right of action available under the Securities Exchange Act to redress denials of membership in an exchange," and finding the denial of exchange membership analogous to the denial of membership in a national securities association like NASD, the Second Circuit in *Desiderio* affirmed the dismissal of the state-law claims. *Id.* at 208. In the same vein, the Eighth Circuit has characterized a breach-of-contract claim premised on NASD's violations of its own rules as an "attempt . . . to bypass the Exchange Act," and in particular the Act's lack of a private right of action to enforce violations of SRO rules. *MM&S Fin.*, 364 F.3d at 912. The court therefore affirmed the district court's denial of a motion to amend the complaint to add such a common-law claim. *Id.* Likewise, the Southern District of California

dismissed contract and negligence claims that were considered "attempt[s] to evade the doctrine that no private right of action exists against the NASD for failing to supervise its members adequately." *Niss v. Nat'l Ass'n of Sec. Dealers, Inc.*, 989 F. Supp. 1302, 1307-08 (S.D. Cal. 1997). And the district court in Sparta originally dismissed the common-law claims against NASD, which it saw as an attempt to "circumvent the lack of a private right of action under the Exchange Act," because those claims were "all founded on the defendants' decision, made in their regulatory capacity, to de-list" the plaintiff's securities. *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, No. 95-cv-3926, 1997 U.S. Dist. LEXIS 4567, 1997 WL 50223, at *3 (N.D. Cal. Jan. 30, 1997). In fact, the *Sparta* district court's observation in its nominally titled "immunity" discussion that "national securities associations and exchanges are . . . exempt from private suit when acting in their regulatory capacity" cited *Feins* as its sole support. 1997 U.S. Dist. LEXIS 4567, [WL] at *4. *But see Shapira v. Charles Schwab & Co.*, 187 F. Supp. 2d 188, 191-92 & n.9 (S.D.N.Y. 2002) (refusing to dismiss common-law tort claim against NASD on private-right-of-action grounds because court did not view complaint "as an attempt to dress up a claim regarding the NASD's failure to follow its own rules").

7

7 In *Shapira*, NASD was sued for tortious interference with prospective economic advantage on the basis of its release of the plaintiff's allegedly sealed arrest record to the plaintiff's potential employer. 187 F. Supp. 2d at 189-90. Although the district court noted that SEC regulations required NASD to maintain questionnaires containing the arrest records of

persons associated with broker-dealers, it rejected NASD's absolute-immunity defense because "NASD ha[d] failed to establish that the action complained of by plaintiff took place pursuant to the NASD's regulatory mandate." *Id.* at 191.

All of the common-law claims asserted in this action, whether cast in tort or contract, seek money damages arising from NASD's erroneous determination that plaintiffs failed to meet the minimum competency standards necessary for participation in the securities industry. Plaintiffs argue that their claims are "distinctly derived from the duties created at common law by the relationship between the parties." Pls.' Opp'n at 23. But the crux of all of their claims is that NASD (itself and through its contractor EDS) breached its duty, which exists solely by virtue of the Exchange Act, to establish a means of ensuring that all persons associated with a registered broker-dealer are qualified to transact securities-related business with the public. See 15 U.S.C. § 78o(b)(7). This duty encompasses the design and administration of the Series 7 as well as the obligation, under NASD's own rules, to inform the exam taker's employer of a failing or passing score, see NASD Manual, Rule 1070(c). There is no express private right of action to enforce § 78o(b)(7), and plaintiffs have not argued that an implied private right of action exists. In any event, such an argument would be futile. As the Second Circuit explained in *Feins*, Congress amended the Exchange Act in 1975 to "expand[] oversight and enforcement powers of administrative agencies such as the SEC" over SROs as part of the "hybrid scheme of self-regulation and government regulation" embodied in the Act. 81 F.3d at 1222. The overall statutory structure, which is designed so that "[g]overnment agencies

work together with the self-regulatory organizations to insure compliance with the statute, the rules promulgated thereunder, and the self-regulatory organization's own rules," *id.* at 1221, suggests just as strongly here as in *Feins* that Congress did not intend private individuals to play a role in enforcing an SRO's Exchange Act duties.⁸ See *generally Tax Analysts v. IRS*, 341 U.S. App. D.C. 419, 214 F.3d 179, 186 (D.C. Cir. 2000) (focusing implied-right-of-action analysis on "discovering legislative intent by means of the language of the statute, the statutory structure, or some other source" (internal quotation marks omitted)). Plaintiffs cannot avoid this result simply by pleading their claims in state common-law terms.

8 Although *Feins* involved a securities exchange rather than a national securities association, both are granted the authority to create and enforce standards of competency. Compare 15 U.S.C. § 78f with *id.* § 78o. Furthermore, both types of entities are SROs and thus are subject to the same SEC and judicial oversight. See §§ 78s, 78y.

NASD also highlights the administrative and judicial remedies provided under the Exchange Act for denials of registration. See NASD's Mem. at 25. To the extent that a failing score on the Series 7 represents a contributing factor in the ultimate denial of an applicant's registration, Congress has provided the exclusive mechanism through which to review that denial. See 15 U.S.C. §§ 78s(f), 78y; *cf. Feins*, 81 F.3d at 1222. Although Congress has not expressly provided any statutory remedy for the mere failure of an examination, the Exchange Act delegates to the SEC (which in turn has delegated to SROs) the responsibility for establishing rules and regulations governing such aspects of exam

administration. See § 78o(b)(7); 17 C.F.R. § 240.15b7-1. [HN19]Under NASD's rules, an applicant who fails an examination may retake the exam after the passage of time, see NASD Manual, Rule 1070(e), but there is no means of challenging the failing score. Given this regulatory scheme, it would be incongruous to allow a claim for money damages based on an improperly scored exam to proceed in federal court against an SRO when an applicant who has experienced the more consequential impact of an erroneous denial of registration cannot proceed with claims seeking damages flowing from that denial, see *Desiderio*, 191 F.3d at 208. This observation is not intended to minimize the seriousness of the adverse career consequences alleged by plaintiffs. Rather, it simply acknowledges the decision by NASD, whose rules are approved by the SEC pursuant to the unique regulatory scheme designed by Congress, to elect an appropriate avenue of relief for an individual who fails an examination. Cf. *Feins*, 81 F.3d at 1222-23. To the extent that plaintiffs are seeking remedies for the negligent performance of an SRO's regulatory duties that Congress did not see fit to provide, this Court will not accede to their request by providing such remedies in the guise of state common-law claims. The self-regulatory structure of the securities market under the Exchange Act preempts

such claims under the body of case law that has evolved contemporaneously with the development of SRO absolute immunity.

Accordingly, plaintiffs' state-law claims, which all seek money damages for defendants' allegedly negligent performance of duties imposed by operation of the Exchange Act, will be dismissed. Hence, the Court has no occasion to reach defendants' remaining arguments.

CONCLUSION

For the foregoing reasons, defendants' motions to dismiss are granted. A separate order will be issued forthwith.

/s/ John D. Bates

United States District Judge

Dated: *September 7, 2007*

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