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Bankruptcy: An Opportunity to Settle Financial ?Industry Regulatory Authority (FINRA) Member-Employee Disputes

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Last year, a U.S. bankruptcy court held that a bankruptcy trustee could settle a Financial ?Industry Regulatory Authority ("FINRA") suit against a broker-dealer by its former employee ?seeking damages and expungement of alleged false and defamatory FINRA Form U-5 ?termination disclosure language, over the objection of the former employee-debtor.[2] Once a ?bankruptcy case is filed by a former employee, the claims become property of the bankruptcy ?estate. In chapter 7 liquidation and in some chapter 11 reorganization cases, a trustee is ?appointed, providing the broker-dealer with an opportunity to settle the claims with the trustee ?and obtain a full release, usually for payment of a relatively small amount.?

FACTUAL BACKGROUND

Clark was terminated by his broker-dealer ("BD") after it received and investigated ?customer allegations that he placed unauthorized trades in their accounts.[3]? ? The BD reported that ?reason for termination in a Form U-5 Termination Notice filed with the Central Registration ?Depository, as required by law. 15 U.S.C. § 78s(d)(1) (mandatory filing requirement); Article V, ?Section 3 of FINRA's By-Laws; FINRA Regulatory Notice 10-39. The information was ?included on the registered representative's public BrokerCheck Report, and he contended it was ?essentially a death knell for his career.[4]? ? Clark commenced a FINRA arbitration proceeding ?against the BD, alleging wrongful termination and defamation and requesting a substantial award ?of alleged actual damages, punitive damages, and expungement of his Form U-5 (the "FINRA ?Action"). Two years after his termination, and while the FINRA Action was pending, Clark filed ?for bankruptcy.

Clark did not initially list his FINRA Action as an asset in his bankruptcy case, or notify ?the bankruptcy trustee, the BD or FINRA of the bankruptcy. He received a discharge and his ?bankruptcy case was closed. The BD learned of the bankruptcy and informed the debtor's ?counsel of its intent to dismiss the FINRA Action because of the bankruptcy non-disclosure. ?The debtor then moved to reopen his bankruptcy, and the bankruptcy trustee hired his ?contingency fee counsel to pursue the FINRA Action for the bankruptcy estate. The BD and the ?trustee agreed to settle for a fraction of the

claimed amount, enough to pay the fees of the trustee ?and his counsel and enable a distribution to the creditors. The debtor objected, arguing that (1) ?his “claim” for expungement was personal and not property of his bankruptcy estate, (2) only ?FINRA had authority to adjudicate and approve settlement of expungment claims, (3) the ?settlement was unfair, and (4) he had an exemption claim to part of the settlement payment in ?any event.

FORM U-5 EXPUNGEMENT IS A REMEDY, NOT A CLAIM?

The bankruptcy court held that expungement of a Form U-5 is not an independent claim ?but a remedy, like an injunction or damages, for wrongful termination and defamation claims. ?While no previous authority had expressly so held, the court cited numerous arbitration rulings ?the BD had provided where expungement was repeatedly sought as a remedy to a claim, along ?with citing FINRA Rules and notices referring to expungement as a remedy to be granted only ?when certain grounds for such relief are present.[5] ? The court also noted that the debtor’s ?Statement of Claim initiating the FINRA Action alleged wrongful termination and defamation, ?and requested Form U-5 expungement in his prayer for relief, not as an independent claim.?

THE CLAIMS IN THE FINRA ACTION BECAME PROPERTY OF THE BANKRUPTCY ESTATE

?Once a bankruptcy case is filed, all of the debtor’s legal and equitable interests, including ?causes of action arising from prepetition events, are property of the bankruptcy estate. Multiple ?authorities cited by the court and the BD have held that a debtor’s monetary and non-economic ?claims for wrongful termination, defamation, and disputes over job promotion and job benefits ?are included in property of the estate.[6] ? In chapter 7 liquidation cases and in some chapter 11 ?reorganization cases, a bankruptcy trustee is appointed and takes control of the litigation and ?other assets. Until and unless exempted out or abandoned out of a bankruptcy estate, the trustee ?has authority to dispose of all such causes of action, including by settlement.

The debtor in *Clark* argued that actions involving a debtor’s professional license are not ?property of the bankruptcy estate.[7]?As the court noted, the cases cited by the debtor hold that a ?non-transferrable professional license is not property of the estate, but neither the bankruptcy ?trustee nor the BD were taking away his license. They were merely settling a cause of action ?which might have an impact on the debtor’s ability to procure future employment.?[8] ?

THE BANKRUPTCY COURT, NOT FINRA, HAS JURISDICTION OVER SETTLEMENT

The debtor argued that the bankruptcy court could not approve the trustee-BD settlement ?agreement because he said FINRA has “exclusive jurisdiction” over all claims and remedies ?relating to expungement of the Form U-5, including the claims asserted in the FINRA Action.[9] ? ?He claimed that FINRA would have to be joined as a party to the settlement agreement, citing ?FINRA Rule 2080. However, the joinder requirement in Rule 2080 was not triggered by the ?settlement because the bankruptcy court was not being asked to order the expungement of ?FINRA records.?

FINRA requires that most disputes between a member broker-dealer and its employee ?that arise out of those parties’ business activities be arbitrated under FINRA’s Code of ?Arbitration for Industry Disputes. *See* FINRA Rule 13200(a). But FINRA Rules do not ?preclude parties from agreeing to mediate and/or settle a dispute in lieu of initiating or continuing ?an arbitration

proceeding. *See*, *e.g.,* FINRA Uniform Forms Guide, p. 2 (encouraging potential ?claimants to consider mediation before initiating arbitration or court litigation, and noting that the ?claimant may submit the claim to FINRA for arbitration if the parties do not fully settle their ?claims). Even after a FINRA arbitration is initiated, it can be settled without FINRA's ?participation pursuant to FINRA Rule 13701. FINRA "must" dismiss the FINRA Action with ?prejudice if requested by the parties. FINRA Rule 13700(a). Only if settlement of the FINRA ?Action includes the affirmative expungement of the Form U-5 is FINRA's approval required. *?See* FINRA Rules 13805, 2080. The *Clark* settlement between the bankruptcy trustee and BD, ?including a provision requiring dismissal of the FINRA Action with prejudice, was accordingly ?entirely consistent with the FINRA Rules. Nothing in the FINRA Rules prohibited or imposed ?any special conditions or restrictions on the parties' decision to settle or the bankruptcy court's ?authority and discretion to approve the settlement under Bankruptcy Rule 9019(a).?

SETTLEMENT FAIRNESS IS JUDGED BY THE BEST INTEREST OF THE BANKRUPTCY ESTATE

When a bankruptcy court considers approval of a settlement, it evaluates: (a) the ?probability of success in the litigation; (b) the difficulties, if any, to be encountered in collection; ??(c) the complexity of the litigation involved, and the expense, inconvenience and delay ?necessarily attending it; and (d) the paramount interest of the creditors and deference to their ?reasonable views on the settlement.?[10] The court reviews the underlying issues to determine only ?whether the settlement falls below the lowest point in the zone of reasonableness. The BD ?explained some of its defenses to the FINRA Action, and the court concluded that the trustee's ?possible success in light of such defenses was less certain and immediate than the settlement.[11]? ?The litigation would also be complex, lengthy and expensive, which supported settlement.?[12]

In the *Clark* case, as in many bankruptcy cases, the court recognized that the settlement ?might not be in the best interest of the debtor. But the interests of creditors are paramount in ?bankruptcy, and the settlement enabled them to receive a distribution from the trustee.?[13]

THE DEBTOR'S EXEMPTION ARGUMENT

The *Clark* debtor argued that the BD's settlement with the bankruptcy trustee was ?effectively a lost wages payment, in which he was entitled to claim an exemption.[14]? The BD ?responded that it was settling to avoid paying professional fees and costs and incurring the ?burden on its personnel to litigate the dispute, not paying wages to the debtor. It also cited ?authority for the point that a debtor who fails to list lawsuit claims in his bankruptcy schedules, ?like the *Clark* debtor, is judicially estopped from benefiting from the claim.[15]? However, it left ?the allocation of settlement proceeds to the bankruptcy trustee, and the trustee agreed to transfer ?a small portion of the settlement proceeds to the debtor on account of his exemption claim.?[16]

CONCLUSION

Whenever a claimant in a FINRA arbitration becomes a bankruptcy debtor, he cedes ?authority over the claim to the bankruptcy trustee. Settlement of a million-dollar claim for ?nuisance value becomes possible. In many cases where the debtor hides his claim from the ?trustee by failing to include it on bankruptcy schedules, whether or not the debtor receives a ?discharge, that claim may be subject to dismissal without even the need to settle with the ?trustee.?[17]? It is easy, and worthwhile, to check a national database of bankruptcy cases to ?determine whether a claimant has filed a bankruptcy case,

or become a debtor after an ?involuntary bankruptcy petition was filed, after alleged causes of action arose.?[18]

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[2] In re Jimmy W. Clark, U.S. Bankr. D. Ariz. No. 2:11-bk-12833-CGC ("Clark Case"), Docket 60, April 24, 2012 (the ??"Order"). ?

[3]? Order n. 4.?

[4]? *Id*.?

[5]? Order at 3, 4; see also Statement in Response to Debtor's Objection and in Support of Trustee's Application to ?Compromise Arbitration Claim, Clark Case Docket 51 ("BD Response").?

[6]? Order at 5; BD Response at 6-8, 10-12.?

[7]? Debtor's Reply to [BD's] Statement in Response to Debtor's Objection to Trustee's Application to Compromise ?Arbitration Claim ("Debtor's Reply"), Clark Case Docket 58 at 2, 3.?

[8]? Order at 5-6.?

[9]? Debtor's Objection to Trustee's Application to Compromise Arbitration Claim ("Debtor's Objection"), Clark Case ?Docket 43 at 3-4.?

[10]? Order at 6.?

[11]? BD Response at 19-23; Order at 7.?

[12]? Order at 7.?

[13]? Order at 8.?

[14]? Debtor's Objection at 4-5.?

[15]? *Hamilton v. State Farm Fire & Cas. Co*., 270 F.3d 778, 782 (9th Cir. 2001). ?

[16]? Trustee's Response to Debtor's Objection to Trustee's Application to Compromise Arbitration Claim, Clark Case ?Docket 54 at 1-2.?

[17]? *See Hamilton*, n. 14 above.?

[18]? A search may be done on a nationwide or single state basis to determine if a person or entity has filed a ?bankruptcy case or if an involuntary petition has been filed through PACER, Public Access to Court Electronic ?Records. It requires registration, and there is a $ .10 per page charge for each document viewed.

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