No. 06-2410

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

DEBORAH GALARNEAU,

Plaintiff-Appellee,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,

Defendant-Appellant.

On Appeal from the
United States District Court
for the District of Maine

REPLY BRIEF OF DEFENDANT-APPELLANT

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MISCELLANEOUS

I. THE EVIDENCE WAS INSUFFICIENT TO SUPPORT GALARNEAU'S DEFAMATION CLAIM.

A. The Verdict Is Subject To Independent Review.

Galarneau suggests that statements in a U-5 are not protected by the First Amendment. Corrected Brief of Plaintiff-Appellee ("Br.") 23. But First Amendment protection is greatest for statements involving matters of public concern. *See First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765, 776 (1978). U-5s, which alert regulators and investors to misconduct by licensed brokers, clearly address matters of public concern. Accordingly, they enjoy full First Amendment protection. *Cf. Jordan v. Metro. Life Ins. Co.*, 280 F. Supp. 2d 104, 112 (S.D.N.Y. 2003). Consequently, this 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.'" *Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485, 499 (1984) (quoting *New York Times Co. v. Sullivan*, 376 U.S. 254, 284–86 (1964)).[1]

[1] Even if the U-5 did not concern a matter of public concern, independent review would still be required. *See DVD Copy Control Ass'n v. Brunner*, 75 P.3d 1, 15, 20 (Cal. 2003) (directing appellate court to apply independent review although matter of public concern not involved); *cf. Levinsky's Inc. v. Wal-Mart Stores, Inc.*, 127 F.3d 122 (lst Cir. 1997) (applying independent review without deciding whether speech concerned matter of public concern).

B. The U-5 Did Not Accuse Galarneau Of Churning.

According to Galarneau, the U-5 accused her of churning Ford's account and engaging in illegal conduct. *See, e.g.*, Br. 25 ("the U-5 statement accus[ed] her of churning"); Br. 49 ("Merrill Lynch accused Ms. Galarneau of *illegal conduct* in the proposed U-5"). In other words, she claims that "inappropriate trading" and "churning" are "synonymous." Br. 24.

In determining whether a statement is defamatory, the focus is on how "the reasonable reader would understand" the statement. *Masson v. New Yorker Magazine*, 501 U.S. 496, 513 (1991). The reasonable reader would not equate "inappropriate bond trading" with either "churning" or "illegal conduct."[2]

The term "inappropriate bond trading" encompasses a broad range of conduct, most of which is not illegal and does not constitute churning.[3] For example,

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[2] Contrary to Galarneau's assertion (Br. 24), Merrill Lynch never argued that "inappropriate trading" and "churning" are synonymous. Indeed, most of the citations presented in Exhibit 1 to Galarneau's brief do not even mention the phrase "inappropriate trading." Moreover, even if a witness had accused her of churning, that would not render the two terms synonymous *to the outside world*. Churning is a subset of inappropriate trading, but it manifestly isn't the entire universe of inappropriate trading. Accordingly, testimony that Galarneau churned Ford's account would prove the truth of the U-5, but it would not cause a reader of the U-5 to equate "inappropriate trading" with "churning." Indeed, because churning is "illegal," not just "inappropriate," an informed reader of U-5s would not assume that Galarneau had been fired for churning.

[3] Indeed, given the term's vagueness and subjectivity, the statement that Galarneau engaged in "inappropriate" trading should be treated as non-actionable

trading, although infrequent, may be inappropriate because it is too risky for the particular client. Similarly, trading, although undertaken for the client's benefit, may be inappropriate because it is unauthorized by the client. Alternatively, trading may be inappropriate, even if authorized and done on a fixed-fee basis, because—like the short-term trading of long-term bonds here—it is fundamentally unwise.

Of course, Galarneau may have committed churning. Ford certainly thought so. JA493. If Galarneau did churn Ford's account, then the U-5 is necessarily true, since churning is indeed one form of inappropriate trading. But the only relevant issue with respect to the defamation claim is whether Galarneau carried her burden of proving that the U-5 contained a false statement of fact *as it was actually written*, and not as she now recharacterizes it. She did not.

C. Galarneau Engaged In Inappropriate Trading.

Galarneau claims that "the case below boiled down to a credibility determination" that Merrill Lynch lost because "[t]he jury simply did not believe the testimony of the Merrill Lynch witnesses." Br. 32. But even ignoring the testimony

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opinion. *See, e.g.*, *McCabe v. Rattiner*, 814 F.2d 839, 842 (1st Cir. 1987) (use of the word "scam" was non-actionable opinion because the word "does not have a precise meaning" and "[w]hile some connotations of the word may encompass criminal behavior, others do not").

of Merrill Lynch's witnesses entirely, there was overwhelming evidence that Galarneau had engaged in inappropriate bond trading.

As explained in our opening brief (at 16–19), Galarneau and her expert, Guild, conceded underlying facts that established the inappropriateness of her trading. Rather than dispute any of those facts, Galarneau asserts that they are "beside the point for purposes of this appeal." Br. 26. She is mistaken. In exercising its "obligation to 'make an independent examination of the whole record'" (*Bose*, 466 U.S. at 499), this Court must take Guild's and Galarneau's admissions into account.[4]

The inappropriateness of Galarneau's trading was also established by the Bates report, which revealed Galarneau's frequent short-term trading of long-term bonds. Corrected Brief of Defendant-Appellant ("ML Br.") 8–9. Focusing on the initial Bates report from August, rather than the revised report prepared a month later, Galarneau contends that the Bates report was flawed because it: (a) commingled realized and unrealized losses; (b) commingled legacy securities and securities bought by Galarneau; (c) did not reflect income derived from the fixed-income securities purchased by Galarneau; (d) did not reflect tax savings allegedly

[4] Evaluating the sufficiency of Guild's conclusory opinion in light of his specific and detailed factual concessions is not a credibility determination.

generated by the bond swaps; and (e) did not reflect appreciation in the securities' value that allegedly occurred after the report's end-date. Br. 13.

Galarneau's critique rests on a faulty premise. According to Galarneau, "[t]he purpose of the report was to determine the profits and losses in the Ford account." Br. 13. But calculating profits and losses was just one purpose of the Bates report.[5] More importantly, by organizing all of the transactions in the Ford account alphabetically by security, the report allowed investigators to see how frequently Galarneau traded bonds and how long she held them before reselling them. JA400.

But even focusing on the report's calculation of profits and losses, Galarneau's criticisms are without merit. Indeed, according to Guild, only one of the report's purported deficiencies—the commingling of legacy securities and securities bought by Galarneau—was "distortive." JA355–JA356. As Galarneau concedes, that and several of the report's other purported flaws were eliminated in the revised report. Br. 13 n.4. Moreover, as suggested by Guild's testimony, the other purported flaws are nothing of the sort. For example, Galarneau's assertion

[5] Whether trading is inappropriate does *not* necessarily depend on whether it was profitable. In any event, the revised Bates report, which excluded legacy securities, shows that the Ford account lost $91,850 under Galarneau's stewardship. JA808. Galarneau's assertion that the account "earn[ed] about $120,000" (Br. 10) is baseless.

that the Bates report erroneously excluded the income derived from the fixed-income securities purchased by Galarneau is a red herring given that (i) the report also excluded the income that would have been earned from the fixed-income securities that were sold by Galarneau; (ii) the proportion of assets held as fixed-income securities scarcely changed over the relevant period; and (iii) by the very definition of a bond *swap*, Ford would have earned approximately the same income from the bonds that Galarneau sold. ML Br. 5–6, 17. As for the purportedly erroneous inclusion of unrealized profits and losses, Galarneau does not explain why they should have been excluded from the analysis, but if they were the total losses would have been approximately $25,000 *higher* than reflected in the Bates report.[6] JA804–JA808.[7]

[6] The amount is calculated by summing the unrealized profits and losses shown in column R of the Bates report. Column S indicates which profits and losses are unrealized. JA805-JA808.

[7] Galarneau's other criticisms are also meritless. Aside from her own *ipse dixit* (JA95–JA97), Galarneau offered no evidence that Ford captured $36,000 in tax savings or that the securities appreciated $65,000 after the closing date of the Bates report. Furthermore, there was good reason not to include the securities' subsequent appreciation, if any, in the Bates analysis. The closing date of the Bates report was the last business day of the month immediately prior to Ford's complaint, upon which Galarneau was removed from the account. Ending the calculations as of that date accurately reflected Galarneau's trading.

In sum, even ignoring the testimony of Merrill Lynch's witnesses entirely, there was compelling evidence—from Galarneau, Guild, and the Bates report—that Galarneau in fact engaged in "inappropriate bond trading" as stated in the U-5.

D. There Was No Evidence Of Malice.

Galarneau acknowledges that she had to prove that Merrill Lynch either knew of or recklessly disregarded the statement's purported falsity. Br. 32. And she admitted at trial that a reasonable person could look at the Bates report and "draw the conclusion that we had done something wrong." JA468. She nevertheless contends that Merrill Lynch knew that its report of inappropriate bond trading was false because Merrill Lynch "had approved the trading and repeatedly told the State that it was appropriate." Br. 33. She is mistaken on both scores.

Merrill Lynch approved Galarneau's trading *before* it had full knowledge of the relevant facts. Galarneau, and her husband, Preston, testified that they gave Ed Coppola, the branch manager at the time Ford opened her account, a "heads-up" that there would be active trading in the account. JA54; JA170. But there is no evidence that they ever informed Coppola that the trading would include frequent short-term trades of long-term bonds. Indeed, Preston *denied* telling Coppola that there would be anything like 167 bond trades over the first two years of the Ford account. JA171. When Galarneau's trading triggered Armor alerts, Galarneau's supervisors asked her for an explanation of the trading and then approved it based

on *Galarneau's* explanation of what she was doing. *See, e.g.*, JA224 ("I accepted Debbie's explanation."). In September 2002, after one of the Armor alerts, Merrill Lynch wrote Ford a letter advising her of the activity in her account. But Ford never responded. JA232. The following month there was a final Armor alert and, having heard nothing from Ford, Galarneau's supervisor again approved the trading *based on Galarneau's explanation*. JA236 ("I had no reason not to believe what [Galarneau] was telling."). Everything changed after Ford's complaint in June 2003. Merrill Lynch then launched the investigation that culminated in the Bates report, which for the first time fully disclosed Galarneau's frequent short-term trading of long-term bonds. Once fully apprised of the relevant facts, Merrill Lynch never again approved Galarneau's trading. That Merrill Lynch had approved Galarneau's trading *prior* to its investigation is not evidence that Merrill Lynch knew the U-5 statement to be false *after* completing the investigation that revealed Galarneau's inappropriate trading.

Moreover, Merrill Lynch *never*, let alone "repeatedly," characterized Galarneau's trading as "appropriate" in correspondence with the State. Merrill Lynch sent the State three letters. The first two were based largely on Galarneau's own statements. JA424; JA432. While the July 2 letter was generally supportive of Galarneau, it never characterized her trading as "appropriate." JA498–JA500. Nor did the September 8 letter, which was narrowly focused on responding to spe-

cific questions posed by the State, none of which concerned the frequency of Galarneau's trades or their overall appropriateness. JA501–JA504; JA509–JA512. And, far from characterizing Galarneau's trading as appropriate, the January 28, 2004 letter specifically stated that Galarneau was terminated, *inter alia*, as a result of "management's ongoing concerns regarding [t]he activity in Ms. Ford's account." JA560.

II. THE DISTRICT COURT ERRONEOUSLY EXCLUDED EVIDENCE RELATING TO THE DRAFTING OF THE U-5.

As we explained in our opening brief (at 13–14), Galarneau's February 5, 2004 letter proposed language to describe the grounds for Galarneau's termination that was substantially similar to the language actually used in the U-5.[8] By show-

[8] Noting that she proposed "add[ing] the words 'that the Firm considered to be lawful' after the reference to the bond trading in the U-5," Galarneau takes implicit exception to the characterization of her proposed language as "substantially similar" to that used by Merrill Lynch. Br. 45. But the language Merrill Lynch used in the U-5—that Galarneau had engaged in "inappropriate bond trading"—did not suggest, let alone state, that Galarneau had engaged in illegal conduct. *See* pages 2-3, *supra*. Galarneau's proposed addition of the phrase "that the firm considered to be lawful" was therefore superfluous. The gist of the statement is the same, with or without the phrase. Although Galarneau now claims that she proposed her language "[r]ecognizing that the U-5 as drafted [by Merrill Lynch] was defamatory" (Br. 45), the February 5 letter she wrote in response to Merrill Lynch's draft made no such assertion. A45-A46. At a minimum, the jury could have concluded that the proposed language and the language actually used bore the same *meaning*, which is what Merrill Lynch's liability depends on. *See generally Masson*, 501 U.S. at 517 (liability depends on falsity of defamatory meaning, not on truth or falsity of precise words uttered).

ing that Galarneau herself (through counsel) had proposed language that had essentially the same meaning as the relevant language in the U-5, the letter would have demonstrated that Merrill Lynch did not act with "malice"—a key element of Galarneau's claim—when it filed the U-5.[9] Galarneau's defense of the district court's exclusion of this important evidence falls far short.

A. The Evidence Was Not Excludable Under Rule 408.

1. Rule 408 does not apply when a claim or defense arises out of settlement negotiations.

Galarneau dismisses as "absurd" our contention that the February 5 letter was admissible under Rule 408 as proof of Merrill Lynch's state of mind. Br. 49. Although we regrettably did use categorical language in making this point, it is not our contention that state-of-mind evidence is *always* admissible under Rule 408. Rather, our more modest contention is that evidence from settlement negotiations is admissible to prove "state of mind"—or any other material fact—when a party's liability or defense *arises out of the settlement negotiations* themselves.

This is true even when state of mind is an element of the claim or defense. For example, in *Domain Name Clearing Co. v. F.C.F. Inc.*, 16 Fed. Appx. 108 (4th Cir. 2001), the defendant's counterclaim, which required proof that the plaintiff

[9] A defendant who publishes language substantially similar to that suggested by the plaintiff does not act with the mental state (negligence or malice) necessary to sustain a defamation verdict. *See, e.g.*, *Veilleux v. Nat'l Broad. Co.*, 206 F.3d 92, 109–11 (1st Cir. 2000).

acted with "bad faith intent," was based on an allegedly extortionate demand made by the plaintiff during settlement negotiations. Invoking Rule 408, the plaintiff objected to the introduction of documents evidencing that demand. The Fourth Circuit held the documents admissible notwithstanding Rule 408 because the "evidence speaks directly to the bad faith determination." *Id*. at 111 n.3. In *Athey v. Farmers Insurance Exchange*, 234 F.3d 357 (8th Cir. 2000), the plaintiff, who brought a bad-faith claim against the defendant insurance company based on the defendant's conduct during efforts to settle the plaintiff's underlying accident claim, introduced evidence from the parties' settlement negotiations. The Eighth Circuit affirmed the district court's admission of the evidence because it "was 'offered for another purpose'"—to prove the defendant's bad faith—although bad faith was an element of the plaintiff's claim. *Id*. at 362; *see also Bruno v. Sonalysts, Inc.*, 2004 WL 2713239, at *8–*10 (D. Conn. Nov. 23, 2004) (where defendant had burden of establishing a non-discriminatory reason for its termination of the plaintiff, evidence that plaintiff communicated desire to resign during settlement negotiations was admissible under Rule 408 as "evidence offered for another purpose" because its exclusion would prevent the defendant from "rebut[ting] allegations of wrongful conduct").

These cases make perfect sense. If the rule were otherwise, a party would be able to use settlement negotiations as cover for committing wrongs with impunity.

For example, had this Court excluded evidence of the defendant's conduct during settlement negotiations in *Urico v. Parnell Oil Co.*, 708 F.2d 852 (1st Cir. 1983), the defendant would have been able to prevent the plaintiffs from mitigating their damages while preventing them from explaining why they failed to mitigate. Similarly, had evidence of the plaintiff's conduct during settlement negotiations been excluded in *Domain Name*, the plaintiff would have been able to engage in precisely the sort of conduct—cybersquatting—that the applicable federal statute was intended to prohibit. Were Rule 408 applicable when a claim or defense is based on events that occurred during settlement negotiations, one party could, through statements made during settlement negotiations, "lull" its adversary into taking certain actions "and then prevent [the adversary] from explaining its actions because the lulling took place around the settlement table." *Bankcard Am., Inc. v. Universal Bancard Sys., Inc.*, 203 F.3d 477, 484 (7th Cir. 2000).[10]

That is precisely what happened here. In her February 5 letter, Galarneau "request[ed]" that Merrill Lynch state that she had been terminated, *inter alia*, for "bond related trades" that the firm considered "not appropriate." A45. Having re-

[10] Such a result would discourage parties from entering settlement negotiations lest they be "blind-sided later." *Savoy IBP 8, Ltd. v. Nucentrix Broadband Networks, Inc.*, 333 B.R. 114, 123 n.9 (N.D. Tex. 2005); *see also Bankcard*, 203 F.3d at 484 ("Settlements will not be encouraged if one party during settlement talks seduces the other party into violating the contract and then . . . accuses the other party at trial of violating the contract.").

ceived that request, it was reasonable for Merrill Lynch to believe that Galarneau would not later claim that a substantially similar phrase—"inappropriate bond trading"—was defamatory, especially given the absence of any contrary warning in Galarneau's letter.

Galarneau denies having lulled Merrill Lynch, asserting:

> Merrill Lynch accused Ms. Galarneau of *illegal conduct* in the proposed U-5; Ms. Galarneau sought to reverse the meaning of the proposed language of the U-5 by inserting language that the conduct was *lawful*. Where is the seduction?

Br. 49. But as explained above (at 2–3), the language that Merrill Lynch proposed and ultimately used did *not* accuse Galarneau of illegal conduct. Thus, Galarneau's request that the word "lawful" be inserted was immaterial—or at least a reasonable jury could have so found, which is all that is necessary to make Galarneau's letter relevant. *See* n.8, *supra*. Having chosen to sue Merrill Lynch for using language substantially similar to that which she proposed, Galarneau cannot invoke Rule 408 to conceal her proposal. It was, therefore, "an abuse of Rule 408" to exclude the February 5 letter. *Bankcard*, 203 F.3d at 484.

2. There was no offer of valuable consideration to compromise a claim.

Even if Rule 408 were applicable when the claim or defense is based on conduct intrinsic to settlement negotiations, the preconditions for excluding evidence under the rule were not satisfied here. Notwithstanding Galarneau's assertion to

the contrary (Br. 48), the February 5 letter did not contain an offer of "valuable consideration *in compromising . . . a claim*" (FRE 408). Although she asserts that "valuable consideration" should be interpreted broadly, *her* interpretation would render the requirement a nullity. The bottom line is that the letter asks for certain language, but nowhere suggests that Galarneau would give Merrill Lynch anything in return.

B. The Evidence Was Not Excludable Under Rule 403.

Galarneau argues that exclusion of the February 5 letter was proper under Rule 403 because "the letter had little, if any, probative value, and because its admission could require testimony from attorneys." Br. 50. Yet evidence is excludable under Rule 403 only "if its probative value is substantially outweighed by the danger of unfair prejudice." Fed. R. Evid. 403 (emphasis added).[11] We have already explained why the letter was important to Merrill Lynch's defense. *See* ML Br. 38–39; pages 9–10, *supra*. Galarneau says that the letter "would have shown the opposite" of good faith (Br. 50), but that was for the jury to decide. There can be no denying that it was relevant to Merrill Lynch's state of mind. As for unfair prejudice, Galarneau relies on the possibility that attorneys might have had to tes-

[11] Evidence is also excludable if its introduction would result in an undue delay, a waste of time, or a confusion of the issues. Here, there was never any suggestion, nor any basis for suggesting, that introduction of the February 5 letter would result in any of these things.

tify. Of course, attorneys testify every day—including in this case. What she probably means is that her *trial attorney* might have become a witness. But it was her choice to have the author of the letter try the case; it would be the height of unfairness to allow her to use that decision as a ground for depriving Merrill Lynch of evidence critical to its defense.

III. GALARNEAU FAILED TO PROVE CAUSATION.

Galarneau—who claimed special, not presumed damages—acknowledges that she bore the burden of proving that her damages, if any, were caused by the allegedly defamatory statement. Br. 34. She implies that potential employers refused to hire her because they construed the U–5 as accusing her of churning. As noted in our opening brief (at 44), however, "where the plaintiff claims that a particular loss has resulted from actions taken by third parties on the basis of a defamatory statement, courts have required that the plaintiff produce testimony of the third parties to establish that the publication did indeed cause the loss." 1 Robert D. Sack, SACK ON DEFAMATION § 10.5.3 (3d ed. 1999); *see, e.g.*, *Simon v. Shearson Lehman Bros., Inc.*, 895 F.2d 1304, 1318 (11th Cir. 1990) (affirming JNOV with respect to special damages because plaintiff introduced "no evidence * * * show[ing] that [the decision maker] specifically considered the slanderous statement in terminating [the plaintiff]."). But Galarneau produced no testimony from the potential employers as to their reasons for not hiring her, instead offering only

her own *ipse dixit*. *Cf.* JA129–JA130. Because the jury's award of $775,000 for lost wages was based on impermissible "speculation or conjecture," it cannot stand. *Cyr v. Adamar Assocs. Ltd. P'ship*, 752 A.2d 603, 604 (Me. 2000).

Relatedly, it is black-letter law that "[o]ne who publishes a defamatory statement of fact is not subject to liability for defamation if the statement is true." RESTATEMENT (SECOND) OF TORTS § 581A (1977), *cited with approval in Faigin v. Kelly*, 184 F.3d 67, 76 (1st Cir. 1999). Here, the U-5 contained *two* negative statements about Galarneau: (i) that she had engaged in inappropriate bond trading, and (ii) that she had utilized time and price discretion. Although Galarneau disputes the accuracy of the first statement, she concedes the truth of the second. JA471. Thus, to prove causation she was required to prove that it was the allegedly false statement, rather than the concededly true statement, that caused her purported injury. Here, precisely because Galarneau chose not to call the potential employers as witnesses, there was no evidence whatever that the true statement alone would not have sufficed to doom her candidacy with those employers.[12] And because Galarneau failed to prove causation, her argument that the burden shifted

[12] Because the U-5 contained two negative statements—one of which Galarneau admits is true—Galarneau's reliance on *Fiori v. Truck Drivers, Local 170*, 354 F.3d 84 (1st Cir. 2004), and *Glennon v. Dean Witter Reynolds, Inc.*, 83 F.3d 132 (6th Cir. 1996), is misplaced. In those cases, the defendant made only one negative statement, and there was therefore no question as to which statement had caused the damages.

to Merrill Lynch to prove "the allocable portion of the injury caused by the other factors" (Br. 35) is irrelevant.

IV. THE EVIDENCE WAS INSUFFICIENT TO SUPPORT PUNITIVE LIABILITY.

Under Maine law, Galarneau was required to prove—by clear and convincing evidence—that Merrill Lynch either acted with express malice (*i.e.*, with ill will toward Galarneau) or behaved "so 'outrageously' that malice could be inferred." *Veilleux*, 206 F.3d at 135. Galarneau does not contend that Merrill Lynch acted from ill will. Rather, she argues that Merrill Lynch acted outrageously because it supposedly "knew that the false accusation in the U-5 would almost certainly result in injury to Ms. Galarneau." Br. 36–37. However, even if the factual predicates to that inaccurate assertion were true, case law—cited in our opening brief (at 47–48) and ignored by Galarneau—makes clear that Merrill Lynch's behavior would not constitute "outrageous" conduct under Maine law. *Tuttle v. Raymond*, 494 A.2d 1353 (Me. 1985), in which Maine's highest court "denied a claim for punitive damages where a driver sped through city streets, ran a stoplight, and struck the plaintiff's vehicle with enough force to shear it in half" (*Curran v. Richardson*, 448 F. Supp. 2d 228, 232 (D. Me. 2006)), leaves no doubt that, absent evidence of actual ill will, a defendant's conduct must be truly horrific before it is "so *outrageous* that malice can be implied." *Staples v. Bangor Hydro-Elec. Co.*, 629 A.2d 601, 604 (Me. 1993) (emphasis in original). Accordingly, even if Merrill

Lynch's conduct were as depicted by Galarneau, it would not sustain the punitive award.

Staples and *Smith*, defamation cases cited by us and ignored by Galarneau, are instructive. In *Staples*, the plaintiff employee was fired after a supervisor falsely accused him of workplace sabotage. There was no doubt that the supervisor's statement was deliberate and that the accusation would almost certainly result in the plaintiff's dismissal. Nonetheless, the court held that, in the absence of clear and convincing evidence of ill will toward the plaintiff, there was "no basis for a finding of deliberate, outrageous conduct" sufficient to sustain punitive damages. *Staples*, 629 A.2d at 604. In *Smith*, a supervisor allegedly accused the plaintiff of intentionally misleading their employer as to a material matter and of then attempting to conceal that fact. The plaintiff was subsequently fired, allegedly as a result of the false accusation. The court allowed the defamation claim to proceed, but precluded recovery of punitive damages—although the allegedly false accusation would likely result in termination—because the "statement [was] not so outrageous as to imply malice." *Smith v. Heritage Salmon, Inc.*, 180 F. Supp. 2d 208, 224 (D. Me. 2002).

Merrill Lynch's alleged conduct in this case is far less egregious than the conduct at issue in *Staples* and *Smith*. Even assuming *arguendo* that the U-5 contained a false statement, the statement was made only after thorough investigation

and without any hint of ill will. Indeed, the statement was not made until after Merrill Lynch had received the Bates report, an independent analysis that even Galarneau admits would allow a reasonable observer to "draw the conclusion that we had done something wrong" (JA468). Given that the conduct in *Staples* and *Smith* was not sufficiently "outrageous" to justify punitive damages under Maine law, *a fortiori* the conduct here is likewise insufficient.

Moreover, the First Amendment precludes "recovery of * * * punitive damages * * * when liability is not based on a showing of knowledge of falsity or reckless disregard for the truth." *Gertz v. Robert Welch, Inc.*, 418 U.S. 323, 349 (1974). That showing must be by "clear and convincing" evidence. *See Bose,* 466 U.S. at 511 n.30; *Dalbec v. Gentleman's Companion, Inc.*, 828 F.2d 921, 928 (2d Cir. 1987). Galarneau has eschewed any assertion of reckless disregard,[13] and has fallen far short of presenting "clear and convincing" evidence that Merrill Lynch had actual knowledge of the U-5's purported falsity. *See* pages 3–9, *supra*; *see also* ML Br. 31–32. Accordingly, the punitive award must be reversed for this independent reason.

[13] *Cf.* Br. 1 (Merrill Lynch filed the U-5 despite allegedly "*knowing* that her trading was appropriate").

V. THE PUNITIVE DAMAGES ARE UNCONSTITUTIONALLY EXCESSIVE.

The Supreme Court has admonished that a $2,000,000 punitive award is "tantamount to a severe criminal penalty" that is warranted only in exceptional circumstances. *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 585 (1996). Such circumstances are absent here.

A. Reprehensibility

"In order to justify a substantial punitive damage award, a plaintiff ordinarily must prove that the defendants' conduct falls at the upper end of the blameworthiness continuum." *Zimmerman v. Direct Fed. Credit Union*, 262 F.3d 70, 82 (1st Cir. 2001). Galarneau claims that Merrill Lynch's alleged conduct lies at the upper end of that continuum. *Cf.* Br. 38. In fact, it falls at the lower end.

The first factor bearing on the degree of reprehensibility is whether "the harm caused was physical as opposed to economic." *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 419 (2003). Citing a recent district court decision, Galarneau asserts that injury to reputation "'is sufficiently personal to remove it from the realm of purely economic.'" Br. 38–39 (quoting *Sunlight Saunas, Inc. v. Sundance Sauna, Inc.*, 2006 WL 3021109, at *4 (D. Kan. Oct. 23, 2006)). She also cites *In re Exxon Valdez*, 472 F.3d 600, 614 (9th Cir. 2006), and *Romano v. U-Haul International*, 233 F.3d 655, 673 (1st Cir. 2000), for the proposition that emotional harm is not "purely economic." Br. 39.

These cases are impossible to square with *State Farm* itself. There, the plaintiffs were awarded $1,000,000 in compensatory damages for emotional distress—largely, "outrage and humiliation." 538 U.S. at 426. If the Supreme Court believed that the infliction of emotional or reputational harm is—like the infliction of physical harm—more reprehensible than the infliction of "purely" economic harm, it surely would have said so. But it did not. On the contrary, in holding the punitive award excessive, the Court emphasized that "[t]he harm arose from a transaction in the economic realm, not from some physical assault or trauma." *Id*.

In any event, notwithstanding the *Sunlight* court's conclusion that reputational harm is not "purely economic" and its further finding that the defamation in that case was the result of actual malice, it went on to hold that the conduct was not egregious enough to warrant a punishment of $150,000, ordering a remittitur to *$50,000*. 2006 WL 3021109, at *7.[14]

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[14] Meanwhile, Galarneau's two emotional distress cases provide weak support for her argument even apart from *State Farm*. In *Exxon Valdez*, the Ninth Circuit relied on the Supreme Court's citation of *Blanchard v. Morris*, 15 Ill. 35 (1853) in *BMW* for the proposition that "punishment should fit the crime." 517 U.S. at 576 n.24. But *Blanchard* involved emotional distress arising out of a *physical* assault (15 Ill. at 36), so the case lends no support to the proposition for which the Ninth Circuit cited it. As for *Romano*, this Court there upheld the *$285,000* punitive award not because "humiliation" is more reprehensible than economic injury, but rather because the defendants "knowingly violated [the plaintiff's] federally protected rights and then attempted to conceal this violation," conduct that this Court characterized as "more reprehensible than would appear in a case involving economic harms only." 233 F.3d at 673.

Galarneau asserts that the second *State Farm* factor—whether "the tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others" (538 U.S. at 419)—is "inapplicable" in this case. Br. 39. She is mistaken. This factor is applicable in all cases. But in cases like this, where there was no risk to health or safety, this factor indicates that the defendant's conduct was less, rather than more, reprehensible.

With respect to the third *State Farm* factor—whether "the target of the conduct had financial vulnerability" (538 U.S. at 419)—Galarneau contends that "she was vulnerable" and that Merrill Lynch's alleged conduct was therefore more reprehensible than otherwise. Br. 39. But it strains credulity to suggest that a person whose "income average[d] between $160,000 and $250,000 per year" (Br. 2) and who already had a lawyer at the time the U-5 was filed (A45) was financially vulnerable. Moreover, the relevant inquiry is not whether Galarneau was financially vulnerable, but rather whether Merrill Lynch *intentionally targeted* her because of that purported vulnerability. In *Exxon Valdez*, for example, there was no dispute that many of the plaintiffs "were financially vulnerable" and that the defendant's "reckless actions harmed them." 472 F.3d at 617. Nonetheless, the Ninth Circuit held that the reprehensibility of the defendant's conduct was not thereby increased because the defendant "did not intentionally target" the plaintiffs because of their vulnerability. *Id*. There is no evidence that Merrill Lynch made the allegedly de-

famatory statement *because* it believed Galarneau to be financially vulnerable. Accordingly, this factor, too, places Merrill Lynch's alleged conduct toward the low end of the reprehensibility continuum.

In connection with the fourth *State Farm* factor—whether "the conduct involved repeated actions or was an isolated incident" (538 U.S. at 419)—Galarneau asserts that "[t]his is not the first time Merrill Lynch has been accused of falsifying a U-5." Br. 39 (citing *Dickinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 431 F. Supp. 2d 247 (D. Conn. 2006)). But *Dickinson* was not before the jury and therefore cannot be used to support its verdict. In any event, the allegations in the *Dickinson* complaint were just that—unproven allegations that are not evidence of anything, let alone "repeated actions." There is nothing in the record that would support a finding that Merrill Lynch repeatedly filed defamatory U-5s.

Finally, Galarneau implies that the jury's finding of malice establishes the fifth *State Farm* factor—"intentional malice, trickery or deceit" (538 U.S. at 419). *Cf.* Br. 40. But the jury did not necessarily find actual malice; its verdict could have rested on implied malice. Even if the jury had found actual malice, however, this Court must still determine whether the evidence supports such a finding. Indeed, in *BMW* the jury found that the defendant had engaged in a "'gross, oppressive or malicious' fraud" (the statutory prerequisite for punitive damages in Alabama). 517 U.S. at 565. But that did not stop the Supreme Court from holding

that "this case exhibits none of the circumstances ordinarily associated with egregiously improper conduct." *Id.* at 580. Here, notwithstanding the jury's verdict, there was no evidence that Merrill Lynch's conduct constituted "intentional malice, trickery or deceit." *See* pages 7–9, *supra*; ML Br. 30–33.

In sum, *none* of the *State Farm* factors is present in this case.[15] That fact—which reflects the minimal reprehensibility of Merrill Lynch's alleged conduct—"renders *any* award suspect." *State Farm*, 538 U.S. at 419 (emphasis added).

B. Ratio

Galarneau contends that the approximately 2.5:1 ratio of punitive to compensatory damages in this case presents "no cause for concern" because this Court has, in other cases, sustained ratios as high as 19:1. Br. 41.

But each of the cases upon which Galarneau relies involved far more egregious conduct and a substantially smaller compensatory award. For example, in *Romano* the defendants "evinced a blatant disregard" for anti-discrimination stat-

[15] Galarneau asserts that a finding of high reprehensibility is nonetheless warranted because "it is clear that the jury believed that the Merrill Lynch witnesses were lying on the stand." Br. 40. Of course, there was no specific finding to that effect by either the jury or the district court. *Cf. Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 439 n.12, 440 n.14 (2001) (appellate courts must defer to "specific findings of fact" by juries and district courts). Nor, unlike in the cases Galarneau cites, is that the only inference that is possible. In any event, in every case in which punitive damages are awarded, the jury is likely to have resolved some credibility questions against the defendant. This cannot, therefore, be a valid basis for finding heightened reprehensibility.

utes and attempted to conceal their misconduct. 233 F.3d at 673. Because that conduct was particularly reprehensible, and because the plaintiff was awarded only $15,000 in compensatory damages, this Court found the 19:1 ratio constitutionally permissible. *Id.* In *Casillas-Diaz*, in which this Court upheld a 3.3:1 ratio, the plaintiffs, who were awarded $300,000 in compensatory damages, "were brutally assaulted and beaten into unconsciousness" by the defendant officers "without legitimate reason or provocation." *Casillas-Diaz v. Palau*, 463 F.3d 77, 82 (1st Cir. 2006).

In two of the cases Galarneau cites, not only was the defendants' conduct particularly egregious and the compensatory award comparatively small, but the ratio upheld by this Court was actually *lower* than the ratio here. In *Zimmerman*, the defendants "mounted a deliberate, systematic campaign to punish the plaintiff as a reprisal for her effrontery in lodging a discrimination claim." 262 F.3d at 82. Given the defendants' "scurrilous" and "unlawful" "vendetta" against the plaintiff, who received $200,000 in compensatory damages, this Court upheld a 2:1 ratio. *Id*. In *Rodriguez-Marin*, in which this Court sustained a 1.6:1 ratio based on compensatory damages of $285,000, the "defendants politically discriminated against plaintiffs" in violation of their federal civil rights. *Rodriguez-Marin v. Rivera-Gonzales*, 438 F.3d 72, 79, 85 (1st Cir. 2006). In short, none of the cases upon which Galarneau relies support the 2.5:1 ratio here.

Contrary to Galarneau's suggestion (Br. 41), *Exxon Valdez* does not "refute[]" the Supreme Court's admonition that "[w]hen compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee" (*State Farm*, 538 U.S. at 425). Sometimes a ratio of greater than 1:1 will be permissible, even if substantial compensatory damages have been awarded—but only in cases involving significant reprehensibility. In *Exxon Valdez*, the defendant's conduct fell in the "mid range" of the reprehensibility spectrum. 472 F.3d at 618. Accordingly, *Exxon Valdez* neither "refutes" the Supreme Court's admonition in *State Farm* nor supports the 2.5:1 ratio here, where the reprehensibility of Merrill Lynch's alleged conduct was minimal.

C. Comparison With Other Cases

When evaluating the constitutionality of a punitive award, this Court looks to other cases involving similar conduct "to determine whether a particular defendant was given fair notice as to its potential liability for particular misconduct." *Davis v. Rennie*, 264 F.3d 86, 117 (1st Cir. 2001). Galarneau asserts that "Merrill Lynch had adequate notice." Br. 42. But ignoring the need for "correct comparison[s]" (*Davis*, 264 F.3d at 117), Galarneau—who does not dispute that the award in this case is the highest defamation award ever imposed under Maine law—fails to address any of the U-5 defamation cases we cited in our opening brief (at 55–

56). The punitive award in each of those cases was substantially smaller than the award in this case even though the defendant's conduct was at least as egregious as Merrill Lynch's alleged conduct here. Thus, "correct comparison" with similar cases confirms that Merrill Lynch lacked fair notice that its alleged conduct could result in a punitive award of $2,100,000.

D. Public Policy

Despite acknowledging the importance of "securities firms be[ing] able to file truthful U-5s without fear of suit by brokers for defamation," Galarneau argues that "policy considerations favor the award in this case." Br. 43.

As Galarneau notes, the public's interest in full and frank U-5 disclosures must be balanced against brokers' interest in not being defamed. She implies that the resulting policy choice is between qualified immunity and no immunity for U-5 statements, suggesting that the large punitive award in this case is unproblematic because, in order to recover at all, she had to overcome the qualified immunity that Maine law confers on U-5 statements. Her theory, evidently, is that qualified immunity is itself ample protection against overdeterrence.

But Galarneau's premise is false. The true policy choice is not between qualified immunity and no immunity, but rather between qualified immunity and absolute immunity. *Cf. Cicconi v. McGinn, Smith & Co.*, 808 N.Y.S.2d 604, 606 (N.Y. App. Div. 2005) ("The matter of absolute versus qualified immunity has

been debated within the securities industry and the courts."); Anne H. Wright, *Form U-5 Defamation*, 52 WASH. & LEE L. REV. 1299, 1325 (1995) ("Whether broker-dealers should be granted an absolute as opposed to a qualified privilege for defamatory U-5 statements is a policy issue."). In fact, in order to ensure that securities firms are not deterred from making frank disclosures, several jurisdictions confer absolute immunity on U-5 statements. *See, e.g.*, *Cicconi*, 808 N.Y.S.2d at 606 ("New York State courts have consistently held that statements made in a Form U-5 are absolutely privileged."); *Fontani v. Wells Fargo Invs., LLC*, 129 Cal. App. 4th 719, 734–35 (2005) (U-5 statements are absolutely privileged under Cal. Civ. Code § 47(b)).

The qualified immunity conferred on U-5 statements by Maine law is the *least* protective standard in existence. As such, contrary to Galarneau's suggestion, qualified immunity alone does not provide an adequate safeguard against the danger of overdeterrence. Thus, lest securities firms be unduly inhibited from making full and frank U-5 disclosures, it is incumbent upon courts to carefully scrutinize the magnitude of any punitive award arising from a U-5 statement. If

allowed to stand, the multimillion-dollar punitive award in this case would deter securities firms from undertaking the full and frank disclosures that make the U-5 a valuable tool in protecting the investing public.

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CERTIFICATE OF COMPLIANCE

I, Andrew Tauber, hereby certify that: (1) this brief complies with the type-volume limitation of Fed. R. App. P. 28.1(e)(2)(B) because it contains 6,897 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii); and, (2) this brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) because it has been prepared in a proportionally spaced type-face, namely Times New Roman 14, using Microsoft Word 2002.

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CERTIFICATE OF SERVICE

I, Andrew Tauber, hereby certify that on March 12, 2007, I caused copies of the Reply Brief of Defendant-Appellant Merrill Lynch, the attached Addendum, and the separate Joint Appendix in the above-captioned matter to be served by overnight courier on the following:

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