Brokerages Deal With Question of Unclean Hands
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In one of the largest combinations in Wall Street history, the Swiss investment bank UBS Warburg announced in July 2000 that it was acquiring PaineWebber, principally for its stable of 8,500 retail stockbrokers.1

As part of the transaction, UBS Warburg paid retention bonuses equaling almost $875 million in order to safeguard the most valuable components of the transaction--the brokers and the client assets under their control.

These retention payments reflect a related practice in the retail brokerage industry: securities firms “raiding” each other for their top brokers and the brokers’ client assets. Securities firms entice brokers to jump ship through the payment of large “up front” signing bonuses (often paid in the form of a forgivable loan) and other compensation, depending on the broker’s commission production history and the amount of client assets the broker controls and can bring with him.

For every raid, of course, there is a defense. Upon joining a securities firm, brokers are usually required to sign non-compete and/or non-solicitation agreements. Firms typically take the position that clients “belong” to the firm and not the broker. Until recently, the most common response to a raid is for the “victim” firm to seek a temporary injunction in court, barring the broker and raiding firm from soliciting business from any of the clients who the broker serviced until a trial on damages and permanent injunctive relief is held.

Until recently, courts have regularly issued injunctions in raiding cases, taking at face value the “victim” firm’s claim that its trade secrets (i.e., client lists/assets) were being stolen.2 Because the raiding firm is just as likely to be the victim of a raid than the aggressor, these disputes are generally settled for some monetary payment based on the trailing 12-month commission production of the departing broker (usually 10 to 15 percent).3

In 1995, in partial response to “raids,” the Securities and Exchange Commission formed a blue-ribbon panel to make recommendations about cleaning up fraud in the securities industry. The panel recommended that brokerage firms abandon the practice of paying up-front bonuses, based on a concern that brokers would churn their clients’ accounts upon joining a new firm. 4

Despite the panel’s recommendations, the practice had (at least until the market correction started in the spring of 2000) increased dramatically among the major brokerage firms due to competition from on-line brokerage trading. 5

The practice of seeking injunctions, however, seems to have recently fallen out of favor, apparently in response to inquiries by state securities regulators that have questioned the practice, at least to the extent that it impedes clients from transferring their assets from one firm to another while the firms haggle over the terms of a settlement. Indeed, Salomon Smith Barney, Morgan Stanley Dean Witter, UBS PaineWebber and Merrill Lynch announced in late 2001 that they have stopped seeking injunctions against brokers in raiding cases. 6

In a related development, the National Association of Securities Dealers, Inc. (NASD) adopted on December 26, 2001 a rule interpretation to the effect that it would be inconsistent with its “just and equitable principles of trade” for a NASD member firm to take any action which interferes with a customer’s ability to transfer his account from one firm to another. 7

NASD member firms, however, are not prohibited from using employment agreements preventing brokers from soliciting customers should they leave the firm, nor are they precluded from enforcing those agreements. Instead, the rule interpretation is limited to prohibiting a member firm from, for example, seeking an injunction barring the client from moving his account to the new firm which the former broker joined, or for seeking relief that would prevent a former broker's new employer from rejecting a customer's account which the broker serviced at his former firm. Even though the rule interpretation guarantees a customer the right to move freely his account from firm to firm, it still permits a former employer to effectively block a customer from choosing his broker of choice, and its practical impact is thus debatable. A client might not go through the effort to move his account to a new firm if it means he still will have to proceed with a new broker.

While it appears that the securities firms' self-declared "moratorium" on seeking injunctions in raiding cases is likely to have come about due to regulatory pressure, there has also been growing resistance by courts from getting drawn into sharp business practices and disputes between brokerage firms which have little to do with the protection of bona fide trade secrets.

"Vockel" Decision

Typically, when a brokerage firm is the victim of a "raid," it will seek expedited judicial relief in the form of a TRO and permanent injunction, barring the departed broker and his new firm from soliciting any of the clients the broker had serviced at his old firm. These injunctions are based on a variety of confidentiality and non-solicitation/non-competition agreements, which purport to vest "ownership" of a client's assets in the hands of the brokerage firm itself. Courts have been receptive to actions for injunctions, which maintain the status quo until the parties resolve their dispute in arbitration.

In May 2000, however, a Philadelphia federal district court issued a groundbreaking decision that portends the end of judicial involvement in the securities industry's practice of one firm stealing away another's top stockbrokers, using large signing bonuses as bait.

In Salomon Smith Barney Inc. v. Vockel, 8 the court denied Salmon Smith Barney's request for an injunction against one of its former brokers who joined a competitor, PaineWebber, principally because several years earlier Smith Barney had lured the same broker away from Merrill Lynch with an offer of a large signing bonus. Although Smith Barney claimed that its confidential client information was being pilfered by the competition, the court held that Smith Barney did not come to court with "clean hands." The court found that Smith Barney demonstrated a similar lack of regard for Merrill Lynch's confidential client information when it snared the same broker six years earlier. The court denied the request for an injunction, and left Smith Barney to obtain whatever monetary damages it could in arbitration. 9

The Vockel case is similar to many raiding cases. Smith Barney lured the broker, Stewart Vockel, away from Merrill Lynch in 1994. In January 2000, Mr. Vockel accepted a new job, with a "sizeable" signing bonus from PaineWebber. While still employed at Smith Barney, Mr. Vockel surreptitiously provided PaineWebber with account statements for about one-half of the clients he serviced at Smith Barney. PaineWebber used those account statements to prepare a mass mailing to the clients in order to solicit and transfer their business to PaineWebber. Mr. Vockel resigned from Smith Barney on a Friday afternoon, and the mass mailing went out the same day. Mr. Vockel also took documents that provided information about each of his clients.

When Mr. Vockel left Merrill Lynch for Smith Barney six years earlier, Smith Barney orchestrated virtually the identical process that PaineWebber was using to entice him to move, including providing him with a large signing bonus.

The court held that in determining whether to grant an injunction, it was constrained to looking only at the conduct of the party seeking judicial relief, not the defendant. The court concluded that Smith Barney was "tainted with inequitableness or bad faith relative to the matter in which

[it] seeks relief" and likened its conduct to a patentee obtaining a patent by deceit and/or misrepresentation and then attempting to enforce it. [10]
The court emphasized that while it did not condone Vockel's conduct, Smith Barney came to court with unclean hands, and that "as a court sitting in equity, we will not aid a wrongdoer." [11]
The court then washed its hands of the entire matter by telling the parties to resolve their dispute in arbitration. [12]

"Frisby" Case

On October 2, 2001, in Morgan Stanley Dean Witter, Inc. v. Frisby,[13] the United States District Court for the Northern District of Georgia refused to issue a temporary injunction against two brokers who left Morgan Stanley for PaineWebber. The court examined the use of injunctions in raiding cases, and found that injunctions generally did nothing to protect confidential information, but had the potential to cause significant harm to the departing brokers' ability to make a living and to the client: "In a time of market volatility, the inability of a client to consult a trusted advisor for even a single day could result in enormous financial losses to the client. This danger outweighs any injury to the Plaintiff that may occur due to the disloyalty of its former employees." [14]

The defendants in Frisby worked as stockbrokers in one of Morgan Stanley's Atlanta, Georgia offices. They signed non-solicitation agreements prohibiting them from soliciting clients they services or learned about at Morgan Stanley for one year after their departure. The two brokers left on the same day and hired the same lawyer. Morgan Stanley claimed in its TRO application that the phone numbers of the clients the brokers had serviced were now incorrect in its computer database, the defendants began an organized mailing to solicit the clients they serviced, thirty of these clients told Morgan Stanley they wanted to move their accounts to PaineWebber, and PaineWebber offered financial incentives for the clients to move their assets. Morgan Stanley claimed that these actions were unlawful, and wanted an injunction pending the outcome of the arbitration proceeding it had started against the defendant brokers.

The court denied the injunction. First, it held that Morgan Stanley would not be irreparably harmed, despite its claim that its loss of customer relationships and good will could not be addressed by monetary damages. The court found that Morgan Stanley in fact had a legal remedy through its ability to obtain an injunction in its arbitration proceeding under the rules of NASD Regulation, Inc., where the arbitration was pending. The court also found that rather than losing good will, Morgan Stanley would lose, at most, commission revenue for which money damages, rather than an injunction, was the proper remedy.

The court also found that Morgan Stanley was unlikely to win the arbitration on the merits. The court held that, under Georgia law, the non-solicitation clause was over broad, because it would prohibit the brokers from soliciting clients serviced by other Morgan Stanley brokers. The court also held that the clients and client information were not trade secrets. The court stressed that Morgan Stanley, when raiding brokers and clients from other firms, argued that under securities industry "custom and practice" client information is not a trade secret. Accordingly, Morgan Stanley was stopped under the doctrine of "unclean hands" from seeking the kind of equitable remedy that it opposed when it stole brokers and client assets away from its competitors.

The court noted that "[a]s long as the departing broker obeys the unwritten rules against taking original records or soliciting clients before resigning, the brokerage firms have a long record of losing arbitration proceedings." The court also cited arbitration awards where securities firms, including Morgan Stanley, were assessed punitive damages for wrongfully obtaining TROs in court against departing brokers.

Finally, the court found that both the brokers (through loss of income) and clients (by being deprived of the counsel of their broker of choice) would be far more damaged through the issuance of an injunction than would Morgan Stanley in losing the clients serviced by two brokers, considering its 60,000 employees in 700 offices worldwide.

Conclusion

The courts in Vockel and Frisby saw through the charade of litigation that invariably follows in the wake of a "raid," and declined to lend judicial sanction to legal proceedings that were, at their core, merely hardball business practices with no legal rights at stake. If Vockel and Frisby's reasoning is accepted by other courts, the victors will be clients who will no longer be cut-off, however temporarily, from the brokers to whom they have entrusted, in some cases, their life savings.

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1. The Wall Street Journal, July 13, 2000, p. C1, "PaineWebber's Chief Finally Says 'I Do' After Finding Acceptable Suitor in UBS" 2. See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Napolitano, 85 F.Supp.2d 491 (E.D. Pa. 2000). 3. The Wall Street Journal, December 4, 2001, p. C1, "Investors Can Move with Brokers More Easily" 4. The Wall Street Journal, March 28, 2000, "Upfront Bonuses Continue Despite Vows to Follow 1995 Panel's Guidelines" 5. Id. 6. Id. 7. NASD Notice to Members 01-36; NASD Press Release dated December 26, 2001, "NASD Adopts New Interpretation Regarding Transfer of Customer Accounts." 8. 137 F.Supp.2d 599 (E.D.Pa. 2000). 9. In Napolitano, another judge in the same judicial district as the Vockel court granted a TRO in a raiding case and did not consider an "unclean hands" defense. 10. 137 F.Supp.2d at 603. 11. Id. 12. Id. 13. 163 F.Supp.2d 1371 (N.D. Ga. 2001). 14. Id. at 1382.