Why Brokers Should Fight Recruitment Bonus, Retention Bonus, Promissory Note And Forgivable Loan Cases

Winning Strategies, Including Offsets and Counterclaims In Broker-Dealer Promissory Note, Signing Bonuses, and Retention Bonus Cases

By

Timothy J. O'Connor

Claims of FINRA-member firms against their former Registered Representatives now comprise approximately 40% of all claims filed with the FINRA Office of Dispute Resolution.[1] This explosion of claims is related in large part to the initiatives of large brokerage firms, which, contemporaneous with the financial crisis of 2008-2009, used Troubled Asset Assistance Program (TARP) funds to retain brokers through retention bonuses and promissory notes in order to prevent further erosion of revenues caused by the crisis.[2]

As a number of large wire houses were hit with regulatory and class action lawsuits associated with structured products, mortgage-backed securities and other investments associated with catastrophic losses that emerged during the financial crisis, many brokers who had signed these notes sought to flee regional firms, boutique firms and Investment Advisory firms. Too often, Registered Representatives of FINRA broker-dealers readily capitulate to demands for reimbursement relating to retention/recruitment bonuses and promissory notes in arbitrations.[3]

In their haste to extricate themselves from these claims, brokers oftentimes overlook the equities underlying their reason for departure from the pursuing broker-dealer. Many hardworking, ethical brokers are oftentimes left with no alternative but to leave their current brokerage firms when faced with pressure to sell unsuitable products, sales practice violations, violations of the FINRA Code of Arbitration Procedure,FINRA and SEC regulations and other situations which may afford brokers offsets as well as counterclaims in note cases filed by brokerage firms.

FINRA Procedures Relating To Promissory Note Cases

[1] Of the total cases filed in 2012, 2,586 (60%) were customer-related claims. The remainder of the cases, 1,713 (40%) were intra-industry claims. (Source: *The Neutral Corner* – 2013)

[2] Regulatory Notice 11-22. The number of promissory note cases more than doubled in the two-year period ending in May, 2011.

[3] In 2013, there were 635,837 Registered Representatives employed by 4,146 FINRA-member firms, maintaining 160,573 offices. (Source: FINRA Statistics & Data, Statistical Review 2008-2013)

Rule 13806 of the FINRA Code of Arbitration Procedure entitled "Promissory Note Proceedings" ". . . applies to arbitrations solely involving a member's claim that an associated person failed to pay money owed on a promissory note . . . to proceed under this rule, a claim may not include any additional allegations."

- Subdivision (a) of the Rule states that, "The FINRA director of arbitration will appoint a sole arbitrator if the associated person does not file an answer, the associated person files an answer but does not allege any counterclaims or third-party claims, or the associated person files an answer which includes any counterclaims or a third-party claim requesting money damages, and the amount of the counterclaims or third-party claims is not more than $100,000.00, exclusive of interest and expenses."

- Subdivision (b)(2) provides that "Three arbitrators will be appointed if the associated person files any counterclaims or third-party claims and the amount of the counterclaims or third-party claims is more than $100,000.00, exclusive of interest and expenses, or is unspecified, or if the counterclaims or third-party claims do not request money damages."

- Subdivision (c)(2) provides that "If the panel consists of three arbitrators, one arbitrator will be a public arbitrator selected from the chairperson roster described in Rule 12400(c) of the Code of Arbitration Procedure for Customer Disputes, unless the parties agree in writing otherwise; one arbitrator will be selected from the roster of public arbitrators; and one arbitrator will be selected from the roster of non-public arbitrators."

Non-Compete and Non-Solicitation Provisions and Related Damages Claimed by Brokerage Firms Against Departing Brokers

Until recently, the position of most FINRA-member firms pursuing note cases against departing brokers has been that of a no-negotiation, no-holds-barred, bullying approach involving claims for recovering on the full amount of the notes, with interest and attorney's fees. Many note claims also include separate claims for loss of revenues, as well as demands for separate injunctive relief designed to prevent brokers from continuing their livelihood premised upon non-compete and non-solicitation provisions contained in promissory notes associated with retention bonus payments. There has been a perception that a number of firms pursue a policy of aggressively and expeditiously pursuing all of these remedies in order to make an example of departing brokers, so that remaining brokers who sign such retention bonuses are discouraged from jumping ship.

While there is a considerable body of conflicting case law on the enforceability of non-solicitation and non-compete provisions, in certain circumstances arbitration panels may tend to be reluctant to enforce heavy-handed provisions which might be perceived as a form of indentured servitude or otherwise unenforceable in law and equity. A sympathetic panel composed of licensed professionals may very well tend to look at a broker's client base as his or her book of business analogous to that of a physician, accountant, independent insurance agent, or attorney.

Equity

Defenses and counterclaims sounding in equity can be the most effective tool in countering a promissory note/retention note case. In the FINRA Dispute Resolution Arbitrators Guide, arbitrators are exhorted to give full consideration to notions of equity:

> Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.[4]

Accordingly, the following July 2004 statement by Linda Feinberg, then-President of NASD (now FINRA), also addresses the province of the arbitrator to strongly weigh notions of equity in their decision-making:

> In SRO NASD arbitration, unlike in court, you get an equitable result. ***You do not have to have a claim that is cognizable under state or federal law; it can be cognizable under NASD rules.*** So, for example, there is only one cause of action under federal securities laws, that's for 10b, it's very limited, it has a very short statute of limitations. The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law . . . (emphasis added).* [5]

FINRA arbitrators are encouraged to seek equity when deciding all cases, including promissory note cases.

Defenses

Intimidated by the overwhelmingly aggressive posture of many brokerage firms, brokers roll over without taking time to consider the defenses and counterclaims available. Statistics bear out that in approximately half of these cases, brokers simply default in appearing.[6]

Common defenses include:

- failure to state a cause of action,
- lack of standing,
- void/voidable as against public policy,

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[4] Domke on Aristotle, from the FINRA Dispute Resolution Arbitrator's Guide, at page 8 (July 2013 Edition).

[5] *The recording of this forum held in Washington, D.C., may be heard (and downloaded) in its entirety at http://www.connectlive.com/evens/nasaa.

[6] Regulatory Notice 11-22. In a majority of completed cases, arbitrators decided the case on the pleadings, and the Respondent broker did not appear.

- estoppel/waiver,
- non-performance due to impossibility,
- unassignability/non-transferability defenses available in equity,
- failure to act in good faith,
- unclean hands,
- breach of contract,
- statute of frauds,
- state and federal wage and labor law violations and
- contact of adhesion claims.

Counterclaims

Counterclaims which brokers should also consider – based on the evidence - include claims for :

- breach of contract,
- common law fraud,
- constructive fraud,
- ERISA claims (29 U.S.C. §1132(g), *et seq.*,
- intentional disparagement of business reputation,
- restitution for failure to pay overtime under state law (12 N.Y.C.R.R. §142-2.2) and federal law (§207 of the Federal Fair Labor Standards Act – 29 U.S.C. §207),
- breach of covenant of good faith and fair business dealings,
- *prima facie* tort,
- *quantum meruit*,
- intentional interference with a contractual course of dealings,
- intentional infliction of emotional and physical harm,
- retaliatory discharge,
- constructive termination and
- constructive discharge.

Providing an effective defense to a broker, who has left his or her brokerage firm, requires a methodical, line-item approach, giving full consideration to all defenses and counterclaims. Brokers, who have been effectively forced from their firms during the pendency of existing retention bonus promissory notes, should not cower from the bullying tactics that some firms are known for.

Particularizing Damages

A more compelling case for these separate categories of damages can be made by the line-item enumeration of each and every separate category of legal and equitable damages associated with these separate causes of action.

In cases where brokers have been effectively rendered unemployable as a result of adverse U-4/U-5 reporting requirements associated with their prior affiliation with the broker-dealer now pursuing them for damages under the promissory notes, a line-item submission of damages broken down by lost income over actuarial working life, loss participation in deferred compensation in ERISA-qualified retirement plans, foregone bonuses, other firm-sponsored retirement plans and benefits, and other damages can make a reasoned and compelling, comprehensive damages claim.

Brokers faced with this situation might be best served to assert these claims in the context of a primary claim before being named as a Respondent in a promissory note/retention bonus claim.

Attorney's Fees

It is also recommended that a comprehensive, itemized attorney's fee application be presented to the panel in closing arguments so that that panel can get a full appreciation of the ordeal your client has had to live through (and pay for), with the claims presented by his or her former brokerage firm.

Brokers defending and counterclaiming against their former brokerage firms are required, as a matter of course, to expend considerable monies for competent defense counsel to assure that they are comprehensively defending each and every claim brought by their former broker-dealer. Additionally, expert witness fees should be summarized and presented in a line-item basis for the panel's consideration.

Expert Witness Reports And Counterclaims by Brokers

In preparation for the hearing, it is recommended that brokers, who have made counterclaims against their brokerage firms in note cases, retain the services of a Certified Public Accountant and/or perhaps a FINRA-licensed professional, who can opine with some level of authority on the respective, separate categories of damages presented at hearing.

Ideally, the preparation of a forecast of lost income, including an itemized report which includes the respective calculations of each category of damages, can make a compelling case at hearing. Such reports should include categories of calculations, such as a forecast of lost income calculation, a net present value (NPV) worksheet, a lost retirement plan contribution worksheet, facts and assumptions utilized in the forecasting report, and the loss of a broker's business.

Likewise, the testimony of a seasoned securities industry professional can be essential in cases involving sales practice violations and firm-wide violations of industry standards, which may have compelled brokers laboring under promissory notes to leave their firms.

A thorough forecast of lost income report and calculations will also include actuarial assumptions, figures and calculations based upon prior years of broker production, taking into account stock market cycles. Additionally, projections of foregone increases in a growing book of business, damage to a book of business associated with negative publicity against the pursuing

broker-dealer based upon systemic fraud in business and sales practice violations, consumer price index (CPI) increases, net present value (NPV) discounting to counter any claim of speculative damages, loss of participation in stock incentives, lost retirement plan contributions, and income tax savings which would have otherwise been earned on contributions to qualified plans, and other various calculations.

Deconstructing The At-Will Employment Posture of Brokerage Firms

While brokerage firms will often contend that they are free to fire their brokers premised upon the at-will employment doctrine existing in a state's common law, equity will not reward improper conduct on the part of brokerage firms seeking to importune their former brokers. Notwithstanding at-will employment clauses in promissory notes, these same notes sought to be enforced by firms can in fact serve to create a whole new and separate contractual course of dealings between the broker and the firm based on the terms of the retention bonus/promissory notes .

Experienced arbitrators appreciate the simple fact that university-educated, licensed brokers, who have developed a considerable book of business and client base over the course of a career, should not be equated with the employment rights of a minimum-wage employee working in a fast-food restaurant.

Many brokers have been constructively discharged by their brokerage firms becasue of newly adopted rules, procedures, and directives of brokerage firms, which were not in contemplation at the time of the signing of the subject promissory/retention bonus note. For example, firms have been known to make the unilateral decision to expropriate a certain portion of a broker's book of business and client base for reassignment to other brokers. Further, reductions of commission payouts and sales credits, as well as the unilateral decision to charge brokers for overhead costs and benefits (and/or the reduction of benefits), office closures, and the termination of incentive, longevity, retirement stock options, and other essential components of a broker's compensation package have left many brokers with no other option than to leave their firms.

A number of brokerage firms have pressured their brokers who have signed notes to subsequently sell unsuitable products, such as variable annuities, structured products and proprietary products. A number of firms have prohibited brokersfrom engaging in the purchase and sale of individual stocks, margin and options trading, and other sales strategies, which they have previously enjoyed engaging in in their clients' accounts at a time when they originally signed their notes. Consolidations, mergers and branch office closures have left brokers faced with no other option but to leave their current firms, notwithstanding the existence of a promissory note.

Retention and recruitment bonus promissory notes are not the iron-clad documents they purport to be. Notes can be successfully challenged, with brokers also being awarded compensatory damages.

Tax Issues

Promissory note cases present a number of tax issues in the context of settlements and arbitration awards. Brokerage firms incorporate verbiage into their promissory notes which afford them the right to accelerate the underlying indebtedness recited in their notes in the event of a brokerage departure prior to the maturity of the note or in the event of non-payment of the note pursuant to the note's terms. In addition to being faced with the prospect of note acceleration, brokers face the risk of the unilateral decision on the part of the brokerage firm to report the *entirety* of the unpaid amount as earned income in the current year of default.

Notwithstanding a favorable award in which a FINRA panel might deem some portion or all of the underlying note to have been paid or otherwise not be due, for whatever reason brokerage firms have been known to hold the threat of claimed effective loan forgiveness with all of the accompanying same-year tax burdens as an additional financial burden and penalty imposed upon the departing broker. These unilateral, arbitrary decisions on the part of brokerage firms can lead to yet further second-stage arbitration or court-venued claims by departing brokers.

Closing Considerations

Promissory note and retention bonus cases present considerable financial risk to both sides of these disputes. Too often, brokerage firms pursue punishing cases against their former brokers, only to subsequently learn that these same brokers may be key, helpful witnesses in subsequently filed customer claims, employment claims of former co-workers, and regulatory proceedings.

Departing brokers who have been doggedly pursued by their former brokerage firms have even been driven to encourage former customers to give consideration to bringing claims based on firm-condoned sales practice violations and other claims based upon firm-wide procedures, which may have had the predatory fact of advancing the firm's interests at the expense of the customer.

Some firms initiate aggressive and even spiteful claims against departing brokers without pursuing any pre-filing due diligence on the prospect of potential counterclaims which their departing brokers may have against *them.*

Within the past five years, a number of brokers have been successful in defeating the claims of their former firms pursuing promissory note cases, as well as prevailing on their counterclaims.[7] Brokers departing firms with unpaid promissory notes face considerable risks, particularly in cases involving brokers who leave their firms for yet bigger up-front monies and/or promissory notes, forgivable loans, and retention bonuses offered by their new firms. In such cases , which might also be coupled with the lack of any viable counter-claims or offsets, the prospect of a full monetary award in favor of the brokerage firm with interest, attorney's fees and forum fees is a likelihood.

Firms that fail to negotiate early resolution of their claims against departing brokers run the risk that the full awards which they obtain against departing brokers end up being worthless pieces of paper and unsecured debts which are discharged in Chapter 7 bankruptcy proceedings. While many firms are signatories to The Broker Protocol , it is submitted that a newly-fashioned Protocol might serve to facilitate a combined crediting arrangement, whereby some portion of the up-front monies/sign-on bonus from the new firm might be credited against a departing broker's note without all the acrimony and expense of a fully pursued brokerage note case, with the former firm benefiting from avoiding potential counterclaims, offsets and prospective customer and regulatory claims relating back to the departing broker's tenure.[8]

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[7] 09-05587 (*Merrill Lynch v. Aquina* ($1.5 Million in compensatory damages paid to the Respondent broker on his counterclaims);

09-06020 (*Wells Fargo Advisors v. Coster*);

10-03377 (*Morgan Stanley v. Gibson* - $4+ million claim on notes denied);

10-04592 (*Merrill Lynch v. Wescott* - $437K note claim denied, $200K+ award to broker on counterclaim);

11-04491 (*Wedbush Securities v. Hansen* - full award to Wedbush on $85K Note, but $100+K award to broker on counterclaim plus $267K attorney's fees awarded to broker);

12-00152 (*Merrill Lynch v. Meischen* - $807K note claim denied; registered rep awarded $8K costs);

12-00766 (*US Bancorp v. Kallman* - $32K claim on note denied; registered rep awarded $20K+ on counterclaim);

12-01106 (*Morgan Stanley v. Ayres* - Compensatory damage award of $637,000.00 in broker's favor on counterclaim greatly exceeded amount awarded on note [$466,696]);

12-01668 (*Popular Securities v. Pagan* - $58K note claim denied; broker awarded $80K on counterclaim);

Wells Fargo Investments v. Shaffer (note claim denied and broker awarded defamatory damages of $75,000.00 and expungement).

[8] The Securities Industry Financial Markets Association (SIFMA) has administered the protocol for Broker Recruiting (also referred to as the Broker Protocol) since May of 2010. Although the stated principal goal of the Protocol is to further the clients' interests of privacy and freedom of choice in connection with the movement of their Registered Representatives between firms. (Source: www.sifma.org)