Volume

2

Law Offices of Patrick J. Burns, Jr., PC

Industry White Paper Series

Understanding the Burden:

Considerations for Going Independent With a Retention or Recruitment Bonus

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Introduction

As part of our ongoing commitment to provide the financial services industry with innovative educational content, *The Law Offices of Patrick J. Burns, Jr.* is pleased to introduce the second in a series of industry white papers that have been specifically developed for financial advisors.

This paper provides a detailed analysis and overview of the issues and considerations for advisors who have received recruitment or retention bonuses and are looking to switch firms or go independent. These advisors need to understand their legal and financial obligations to their soon to be former firms should they decide to leave.

Developed in partnership with Nexus Strategy, LLC, a leading consulting firm to the wealth management industry, this report will highlight the recent industry trends that have led to tens of thousands of advisors signing retention and recruitment packages. The paper will also detail the structure of these deals, provide advice and guidance for managing transitions, and discuss several case studies.

We invite you to learn more about the industry's important legal, compliance, and regulatory issues by logging on to our website at www.pjblawoffice.com or that of our affiliated company, Advanced Regulatory Compliance www.advreg.com.

Executive Summary

"…many advisors who signed the deals may not have fully understood the legal, tax, and financial implications of these agreements should they leave their firm…"

In response to the recent large-scale movement of financial advisors to independent channels, Wall Street firms are attempting to slow down the migration by offering lucrative retention and recruitment packages in the form of forgivable loans secured by promissory notes, to top advisors.

These retention and recruitment packages have been very successful and tens of thousands of advisors across the industry have accepted them. However, many advisors who signed the deals may not have fully understood the legal, tax, and financial implications of these agreements should they decide to leave their firm at a future date.

If an advisor who signed a retention or recruitment package decides to leave their firm prior to their note becoming fully forgiven, the advisor will have to pay back any outstanding balance. This can be quite an expensive proposition, particularly when considered from an after-tax perspective.

When it comes to deciding whether or not to make a transition when an advisor has signed a recruitment or retention package, it is extremely important to set expectations regarding the settlement of a promissory note. Signing advisors are liable because they executed a legally binding agreement and accepted compensation as consideration. Wall Street firms will pursue these cases, often using FINRA arbitration to enforce the terms of the deal.

There have been some notable and high profile cases where departing advisors were able to settle these deals at a discount or prevailed in arbitration. Advisors have a better chance at success when they have developed a sound legal strategy, taken appropriate actions, and retained knowledgeable legal counsel to minimize their risks.

Background

"Thousands of advisors took the opportunity to move their businesses to models that allowed them the freedom and flexibility to operate their practices in the way they wanted, unencumbered by the damaged Wall Street brands."

The financial crisis of 2008-2009 had a wide-ranging impact on the financial advisory business as legacy Wall Street firms were humbled and nearly brought to their knees by a series of wide-ranging events, product failures and mismanagement.

The damage that resulted from the investment banking activities of the Wall Street firms negatively impacted their wealth management divisions, causing financial instability and the looming threat that the security of client assets could be jeopardized. This unstable environment gave financial advisors an incentive to move their practices to other channels.

The key beneficiaries of these moves were the independent financial advisor channels of the Registered Investment Advisers (RIA) and Independent Broker-Dealers. Thousands of advisors took the opportunity to move their businesses to models that allowed them the freedom and flexibility to operate their practices in the way they wanted, unencumbered by the damaged Wall Street brands. Additionally, the independent, fee-based models of offering non-conflicted advice along with the ability to build multi-million dollar business assets that they could monetize when they retired was appealing.

In response to the large-scale independent movement of financial advisors, Wall Street firms attempted to stop the bleeding by offering lucrative retention packages in the form of forgivable loans secured by promissory notes, to their top advisors in order to retain them.

The retention packages were very successful and tens of thousands of advisors across the industry accepted them. However, many advisors who signed the deals may not have fully appreciated the legal, tax, and financial implications these deals would have should they decide to leave their firm at a future date.

At the same time the retention deals were being offered, Wall Street firms were also engaging in an aggressive recruiting war amongst themselves, offering staggering multi-million dollar, front-end loaded recruitment packages to top advisor teams. Much like those who signed and received the retention packages, the advisors who signed these deals and accepted them, did not fully understand the legal, tax, and financial implications should they ever want to leave.

Retention and Recruitment Packages

"Wirehouse firms do not want to set any precedents or expectations in the industry that they will not pursue these types of unpaid balances."

Retention packages are typically structured as loyalty bonuses and as such, are looked at very closely by firms when an advisor is leaving with a balance due on the promissory note. Wirehouse firms do not want to set any precedents or expectations in the industry that they will not pursue these types of unpaid balances. The recent raft of arbitration cases of firms pursuing advisors is ample evidence of this fact and is a reason for caution for advisors considering leaving with a balance due on a retention deal.

Generally, retention packages are compensation paid to advisors to stay with their current firm and are offered during periods of ownership changes, or some other major event or circumstance that would cause senior management to fear that advisors may leave the firm.

If an advisor who signed a retention package decides to leave the firm prior to the note becoming fully forgiven, the advisor will have to pay back any outstanding balance. This can be quite an expensive proposition, particularly when considered from an after-tax perspective.

For example, if a bonus payment was calculated at $2 million and is treated as a forgivable loan, then that amount would be considered taxable income and the advisor would owe the IRS and their state roughly $750,000 to $1 million, depending on their tax bracket. If they wanted to leave the next day, they might owe the wirehouse the full amount, $2 million, yet they only netted perhaps half of that. Thus, it is no surprise that many in the industry consider these retention deals to be not just "golden" handcuffs but rather, real handcuffs.

Recruitment packages are compensation paid to an advisor to switch firms. These packages are also forgivable loans subject to a promissory note. These packages differ from retention packages in that it is typically possible for advisors to structure a payment plan and perhaps receive a discount on the outstanding balance due. It is important to note that advisors cannot walk away from a firm and expect that firm to forget about it, write it off, or settle the claims for mere pennies on the dollar. Advisors considering leaving with a balance due should speak with qualified legal counsel prior to their transition so they have a good idea of what their options look like in repaying a recruitment package.

Wirehouses have been known to work with advisors with balances due pursuant to recruitment deals. Typically, a firm will offer some type of reasonable repayment plan, perhaps 2-3 years, and a discount subject to executing a new promissory note, a settlement agreement and a "confession of judgment" allowing the wirehouse to bypass the arbitration process and get a court judgment.

When considering the post-departure treatment that an advisor may receive from their soon to be former firm, there are many issues to take into account. Advisors who leave very early into a recruitment package will generally face a tougher road in settling their notes than those who are further into their agreements. A big factor depends on their branch or complex manager. These managers wield power behind the scenes in determining how note negotiations play out. Advisors who leave on good terms with local management will generally fare better in note negotiations than those who leave on bad terms.

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Factors such as personalities, the way the advisor leaves the firm, and avoiding unfounded threats of litigation against an advisor's prior firm, will also have a large impact on how the negotiations play out. The old saying, "you can catch more flies with honey than vinegar" is apt advice for advisors in these situations.

Promissory Note Structures

Promissory notes vary depending on the negotiated terms, however most have a common structure.

The length of the promissory note typically will be from 7-14 years and may include language stating that the advisor cannot compete for and/or solicit clients until the note balance has been paid in full. This provision is actually at odds with the clear language of the Protocol for Broker Recruiting, which states that as long as the advisor follows the Protocol, advisors generally shall have no liability for non-compete/non-solicitation provisions of their employment agreements.

Other provisions include terms for how outstanding balances due shall be fully accelerated when an advisor departs before the note is paid off. Additionally, brokerage accounts at a firm may be seized as collateral against outstanding balances due.

Transition Considerations for Advisors with a Recruitment or Retention Bonus

When it comes to deciding whether or not to make a transition when an advisor has signed a recruitment or retention package, it is extremely important to set expectations regarding the settlement of a promissory note.

Signing advisors are liable because they executed a legally binding agreement and accepted compensation as consideration. Wirehouses have made too much of an investment in these deals for them to not pursue those who would leave without fulfilling their obligations in terms of length of service or paying back the note. Wall

Street firms will pursue these cases, often using FINRA arbitration to enforce the terms of the deal.

"…advisors should make all attempts to avoid arbitration due its costs and the possibility that losing an arbitration can result in paying their attorney fees, the other side's attorney fees, the cost of the arbitration and the note's principal and interest."

Any recruiter, lawyer or industry professional that suggests otherwise should be avoided as a resource in helping advisors negotiate forgivable loans. Advisors may be misguided by these professionals due to a lack of experience in retention and recruitment note payoffs leaving the advisors exposed to legal and financial risks.

In these matters, advisors should make all attempts to avoid arbitration due to its costs and the possibility that losing an arbitration can result in paying their attorney fees, the other side's attorney fees, the cost of the arbitration, and ultimately the note's principal and interest.

There are legitimate cases for getting major reductions on principal amounts of notes, such as claims related to sex, gender or race discrimination with strong evidential proof. These are just a few of the many reasons advisors have for contesting balances due on their outstanding notes.

FINRA's New Approach to Arbitrating Bonus Disputes

FINRA recently released a **Regulatory Notice 11-22** effective June 6, 2011 regarding the arbitration of promissory notes. FINRA will appoint chair-qualified public arbitrators to panels resolving promissory note disputes instead of appointing chair-qualified public arbitrators also qualified to resolve statutory discrimination claims. The amendments apply to all promissory note proceedings in which FINRA has not sent lists of arbitrators to the parties as of the effective date.

In 2009, FINRA implemented new procedures to expedite the administration of cases that solely involve a brokerage firm's claim that an associated person failed to pay money owed on a promissory note. Under the procedures, FINRA appoints a single chair-qualified public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims (a statutory discrimination-qualified arbitrator) to resolve the dispute. These specially qualified arbitrators are public chair-qualified arbitrators who also are attorneys familiar with employment law and have at least ten years of legal experience. In addition, they may not have represented primarily the views of employers or of employees within the last five years.

FINRA proposed using statutory discrimination qualified arbitrators because of the depth of their experience and their familiarity with employment law. Since implementing the new procedures, FINRA found that promissory note cases did not require such extensive experience or depth of knowledge. In a majority of completed cases, arbitrators decided the case on the pleadings and the respondent broker did not appear. In addition, the number of promissory note cases has more than doubled in the past two years.

"It is often mistakenly believed that wirehouse firms consistently win FINRA arbitration cases against advisors…"

As a result of this substantial increase, it became more difficult to appoint panels in these cases using only statutory discrimination-qualified arbitrators. Therefore, FINRA amended the Code of Arbitration Procedure for Industry Disputes (Industry Code) to provide that FINRA will appoint a chair-qualified public arbitrator to a panel resolving a promissory note dispute instead of appointing a statutory discrimination qualified arbitrator. Chair-qualified arbitrators have completed chair training and are attorneys who have served through award on at least two cases, or, if not attorneys, are arbitrators who have served through award on at least three cases. The rule amendments ensure that FINRA has a sufficient number of qualified arbitrators readily available to resolve these matters.

Case Studies

It is often mistakenly believed that wirehouse firms consistently win FINRA arbitration cases against advisors who are forced to pay back their promissory notes, attorneys' fees for both parties, and interest. The following cases are examples that the balance of justice is not tipped in the favor of wirehouse firms, and when an advisor has a strong enough case, it may be worth it to fight back.

Bank of America Merrill Lynch vs. Angel E. Aquino

In this dispute, Merrill Lynch alleged that Aquino had breached a promissory note from April 2008 and obtained unjust enrichment after failing to pay the firm back. Aquino was employed at Merrill Lynch from September 2006 through September 2009 in Guaynabo, Puerto Rico. Merrill Lynch requested $969,870 for the promissory note, plus interest, attorneys' fees and costs that brought the total damages sought to roughly $1.5 million at the close of the hearing.

Aquino brought a counterclaim alleging breach of contract and termination without cause. Aquino also requested the expungement of his form U-5, alleging that defamatory language was included. In the counterclaim Aquino requested $150 million, $100 million of which was for punitive damages, $50 million for the current value of commissions that he could have made over his lifetime.

At the close of the hearing, the $150 million claim had declined to $13.29 million. In the outcome of the case, the FINRA panel ordered that the language in Aquino's form U-5 be changed to: "Mr. Aquino was terminated not for cause." The FINRA panel also sided with Aquino and ordered Merrill Lynch to pay him $1.55 million in compensatory damages.

This case demonstrates that advisors can win arbitration cases against wirehouse firms in promissory note cases and leave with their U-5 intact.

Wells Fargo Investments, LLC vs. Kenneth C. Shaffer

"As a result, the arbitration panel found the subject promissory note to be both procedurally and substantively unconscionable. Wells Fargo's claims against Shaffer were denied entirely."

In this case, the claimant/counter-respondent, Wells Fargo, attempted to go after their former broker Kenneth Shaffer for the balance due on a $74,617.76 note plus interest, costs and attorneys' fees.

Shaffer filed a Counterclaim against Wells Fargo for $170,000 in compensatory damages, $830,000 in punitive damages, $500 in attorneys' fees, $1,575 in costs, and an amendment of his Form U-5, and various Panel orders. In addition, Shaffer included a number of allegations including, denial of disability benefits, wrongful termination, and failure to pay commissions, among others.

As a result, the arbitration panel found the subject promissory note to be both procedurally and substantively unconscionable. Wells Fargo's claims against Shaffer were denied entirely. Additionally, the panel held that Wells Fargo was liable to Shaffer for $75,000 in defamatory damages regarding the language in Shaffer's U-5 and the panel also ordered that the termination comment in Shaffer's U-5 be expunged entirely and replaced. In addition, Wells Fargo had to pay the $7,200 in FINRA hearing session fees for both parties.

This case demonstrates that FINRA arbitration panels are not always stacked against advisors as many believe. Advisors with solid cases can prevail against their former firms and receive damages when appropriate.

Conclusion

Advisors who have received recruitment and retention packages need to consider the legal and financial implications for leaving their signing firm prior to making a switch to a competing firm or going independent. As part of this process, advisors need to seek out knowledgeable legal counsel to set expectations for paying back their promissory notes and avoiding expensive and risky arbitration as wirehouses will pursue advisors who neglect to pay off their loans. For many advisors, the path to independence with all of its benefits is worth repaying their notes and as long as contractual obligations are fulfilled, those costs can be more than made up over the long run.

About the Law Offices of Patrick J. Burns, Jr.

Patrick J. Burns, Jr., Esq., is the managing attorney with *The Law Offices of Patrick J. Burns, Jr., P.C.,* and also the President of *Advanced Regulatory Compliance, Inc.* He is a member of the California, New York and New Jersey Bars, and received his Juris Doctorate degree from Southwestern University School of Law in Los Angeles, California and Bachelor of Business Administration degree from Pace University's Lubin School of Business in Pleasantville, New York. Mr. Burns began his professional career with a New Jersey based law firm and then worked in a legal/compliance capacity for several financial services firms located in New York City and Los Angeles. During his financial services career, he acquired numerous FINRA and insurance licenses. Mr. Burns is a frequent industry speaker and a member of the Financial Planning Association and the Southern California Compliance Group.

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