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Can you take it with you?

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When an advisor leaves a wirehouse before his term on his forgivable loan is up, the firm often demands he pay back the balance at once. Mark Thierman is behind a new class action lawsuit that could change that.

In 2004, Thomas Banus moved his book of business from discount brokerage Quick & Reily to Smith Barney. As an incentive to join Smith Barney, Banus was offered about 10 percent of his trailing 12-months production in upfront cash — a forgivable loan. That loan amounted to about $46,000. Each year over seven years, an equal portion of the loan was forgiven. But two years into the job, Banus left Smith Barney. Since then, the firm has been demanding that Banus pay back the balance on the loan with interest, equal to around $39,000, immediately, as stipulated by a clause in his employment contract. In fact, on August 12 a FINRA arbitration panel ordered Banus to do so. But Banus is fighting back.

Curt Goodwin

That same August day, Banus's lawyers Mark Thierman and Leon Marc Greenberg, filed a class action lawsuit against Citigroup that says advisors shouldn't have to pay back upfront money all at once — or even at all — because such clauses in employment contracts are unfair and unenforceable under contract and New York labor law. The complaint filed on behalf of Banus also represents over 500 other advisors, and that number could jump to 1,000 or more, Thierman says. Already something of a legend in the brokerage business, the labor law attorney has successfully wrung millions in settlement money out of wirehouse firms in recent years, to make up for back overtime pay to brokers.

What happened between Banus and Smith Barney is not uncommon — especially these days, with so many wirehouse advisors switching employers, lured away by recruiting bonuses or by the appeal of the independent life. Since November 2008, over 8,500 wirehouse reps have switched firms; just over half, or around 4,800 of them, have moved to other wirehouses, according to Discovery Database. “Paying back leftover upfront bonus money is becoming more of an issue now because of advisor movement,” says J. Steven Parker, a partner at Atlanta-based Page Perry, who specializes in securities litigation and regulation. Firms also tend to get more aggressive about recovering that money in down markets, attorneys say.

Like Banus, brokers who leave their firms before their promissory notes have matured are typically required to pay back the balance of the loan they received when they first joined. And like Banus' arrangement, these forgivable notes are set up so that an equal portion of the total loan is forgiven annually on the anniversary date the rep joined the firm. But when an advisor leaves a firm before the entire loan has matured, the remaining balance is “accelerated,” with the firm insisting that the balance be paid at once with interest.

In the complaint, Thierman argues that these payback arrangements violate contract law on several points. First, the payment acceleration clauses constitute a penalty for an employee's departure, something that is not allowed under general contract rules. Further, the clauses are so unfair and one-sided that no reasonable or informed person would agree to them. In addition, broker employment contracts that contain such clauses are themselves “illusory,” or unenforceable under contract law, because they are too one-sided. For example, Citigroup can terminate a broker's employment and accelerate the loan with no loss to itself. But the broker must pay his debt with interest

even if he leaves the firm not because he wants to, but because he is unable to meet the production requirements set out in his contract. This gives Citigroup too much power, which could be argued to violate contract law. “The argument is that the promissory note is there to keep an advisor from leaving before the loan is paid off,” says one securities lawyer who did not want to be named because he represents both advisors and firms.

Thierman's final argument is that Citigroup did not fulfill its contractual obligations to Banus or the other members of the class, because alleged mismanagement of the firm was disruptive to their ability to do business. All firms have a duty of good faith and fair dealing, and in Citigroup's case, this means the firm had to provide the service and security necessary for a broker employee to attract and/or retain clients, says the complaint.

“The question becomes, ‘Did Citi breach that duty?’” asks Thomas B. Lewis, a partner at Stark & Stark. “That's what makes this case interesting.”

Banus says he left Smith Barney because the firm was not providing the client service it had promised, which interfered with his ability to do business. “I left because my client were leaving the firm. They told me to find another firm. At the end of the day my duty is to them,” Banus says. (This was back in 2006, before all of the recent turmoil on Wall Street and in the markets.)

Citigroup, of course, disagrees with the arguments made in the lawsuit. “We believe the suit to be without merit and we will defend ourselves against these claims,” a spokesperson says in a statement. At press time, the firm had not filed a response to the complaint.

THE UPSHOT

Thierman, a labor lawyer by trade, was the architect of class action overtime suits on behalf of brokers that kicked off in 2005. (Thierman has settled for tens of millions of dollars with every major wirehouse regarding the overtime issue, including a $98 million deal with then Citigroup Smith Barney.) He's taking on the Wall Street brokerages again, and if he has his way, contracts like Banus' will be void and brokers won't have to pay back those upfront payments when they leave a firm. At the very least, they won't have to pay them back immediately upon departure as the acceleration clauses require. What's more, advisors who have already paid back their loans could be awarded damages. At Citigroup, such damages could add up to $50 million or more, attorneys and compensation consultants estimate. If the suit against Citigroup goes well, Thierman says he may file similar suits against other wirehouse firms with similar contracts.

Some lawyers think Thierman could make a big splash with the Banus lawsuit. “These contracts look the same at each firm,“ says one securities lawyer. “This could be huge if it goes in favor of the brokers. It could be as big as the wage and hour cases because it involves all the major firms. It could change the way these contracts are written.” Others think that Thierman has a tough battle ahead of him. “At the end of the day, defense will say, ‘A contract is a contract. You knew what you were getting into when you signed the deal. Now, own up to it,’” says Bill Singer, securities attorney and shareholder at Stark & Stark.

As for Thierman's claims that Citigroup didn't fulfill its contractual obligations to Banus, some lawyers say this is a stretch. “The defense will say, ‘We never guaranteed that there wouldn't be a bear market or a recession,’” says Singer. “We didn't act in bad faith, we acted in good faith under the circumstances.’” Further, Singer says the arguments made in the case aren't novel (they're sometimes argued in arbitration cases for individual advisors). What advisors should watch for is the case's pending status as a class action suit, he says. If it's approved as a class action, it could cause major waves in the industry.

He continues, “It's a very difficult contingency to fathom. On the one hand, Citi could be unable to demand repayment of some employee forgivable loans based upon the ruling. On the other hand, the ruling could be so limited as to impact Citi in a minor way and not expose it to future claims by reps who previously settled or lost similar cases,” Singer says. The most likely outcome would be that the practice of employee forgivable loans would largely disappear if the ruling goes against Citi, he says. But in that case, more “novel inducements will be created, or the practice could be eliminated altogether in favor of more traditional bonuses.”

The question is which, if any, of Thierman's arguments might stick and what the court's response might be. Thomas B. Lewis, a partner at Stark & Stark, says that while contracts are constantly being tweaked to address state laws, he doesn't expect the case to result in a mass contract re-write at Citi or other wirehouse firms. “The plaintiff has an uphill battle. For the most part, courts and arbitration panels enforce promissory notes. But to what extent? That's to be determined.” If the class action is successful, he expects firms may offer some kind of discount to advisors who owe money on their notes. Advisors who have already paid back their notes could be partially reimbursed. “I don't think there's going to be a walk-away situation where the class gets everything it's asking for,” Lewis says.

Some see negative consequences even if the suit is successful. “Advisors should be careful what they wish for in this suit,” says Andy Tasnady, a compensation consultant in Port Washington, N.Y. “Firms might decide not to give anymore cash upfront if the suit is successful. Advisors might end up shooting themselves in the foot if they plan on jumping, because firms might decide that bonus money is better paid out on the back end rather than upfront.”

Of course, there are a few other complications, too. For one thing, Banus was ordered to pay back Citigroup by a FINRA arbitration panel the same day his lawyers filed their class action against the firm. That may prove problematic for the plaintiff.? “The court might decide Banus cannot participate as a plaintiff in the class action because a FINRA panel decided Citigroup's claim for payment on the promissory note he signed. Plus, brokers must pay arbitration awards within thirty days of receipt unless they?file a motion?in court to vacate,” says Doug Stone, a New Rochelle, N.Y., securities lawyer. But Thierman says that other plaintiffs will be added to the complaint, and doesn't see these issues as a problem in the class action.

PAYBACK

Leaving before a promissory note is completely forgiven is common in the industry. And while there are no figures available about how much money is owed, securities lawyers who deal with the firms and reps involved say collections activity has increased over the last year. They

say the brokerage mergers (and tanked stock) in the industry inspired plenty of brokers to jump ship for another firm regardless of the balance left on their notes. These days promissory notes can tie up a broker for up to nine years. “That's an awful long time to stay with one firm for the sake of a promissory note,” says the securities lawyer.

Most of the time, the departing advisor will pay back the balance of the promissory note with the help of the bonus he got from his new firm. Sometimes, the firm and departing rep may work out a deal where the advisor pays back the loan over a period of time — instead of accelerating the note as the contract states. But sometimes the firms get aggressive about collecting the debt — which could range from $10,000 to several million dollars. Marc Dobin, partner and director of the Financial Services Division at LaBovick & LaBovick, says, “It's a significant amount of money to both the broker and the firm. If the firm doesn't go after a $100,000 debt, the broker with $50,000 in debt won't think twice about leaving.”

Usually the demand for payment is issued during the rep's exit interview with the branch management. Reps are also notified of the debt in written notice by the firm's collections office. If the rep does not respond and does not pay the debt, the case is brought to arbitration. Typically, such cases are ruled in favor of the firm, according to securities lawyers. “Advisors don't get much sympathy from the arbitration panel in these cases. They say a note is a note and you have to pay it,” says Stark & Stark's Lewis.

Sometimes though, firms will hire an outside agency to collect the money from brokers. One such company is run by Michael Colombo, president of StreetWide Asset Recovery Group, a full service collection agency that works solely in the financial services sector. Firms hire Colombo to recover debt from both brokers and investors. About 70 percent of debt he recovers is broker related, and a large portion of it is related to upfront bonus repayment. “Over the last year, firms have been focusing more on collecting these debts from brokers. When times are good they don't go after it right away. Now they are,” Colombo says.

Lewis says branch managers are sometimes the ones who push for more aggressive action against the departing rep. “From a manager's perspective, if you have a team of five or six people who leave, there could be half a million in bonuses they owe. That debt affects the branch directly. Getting it back would have a positive effect,” he says.

Another issue firms consider when deciding how aggressively to act is where the departing broker jumped to. “They look at whether the broker went to another wirehouse for a big deal. If he went to a lower tier firm, the firm might realize the move was the result of not being able to meet production requirements. The firm might be more inclined to ease up and work out a discount with the advisor. How the firm treats the pursuit is based on how big the advisor is, where he went and what kind of deal he may have received,” says the securities lawyer who wished not to be named.

“At the end of the day, the firm will say the upfront money is a loan given to advisors. And that the prudent thing would have been to put the money in a bank and not spend it,” Singer says. But Thierman's answer to that: “Once you give employees money, consider it spent. You can't ask for it back.”?

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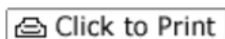

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