When to Defend Promissory Note Cases? That One in a Thousand Case.

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In the financial services industry, and more specifically that part of the business involving retail brokers, the Employee Forgivable Loan (EFL) – upfront or signing bonus - is a recruiting tool with great allure. Brokerage firms entice brokers to leave their current job and take their book of business with then with the promise of a significant financial inducement: an immediate payment equal to 100% or more of the broker's trailing 12 month gross commissions. Perhaps a back-end bonus or kicker will be added to the package depending on production and/or "assets under management", so a broker with a certain level of production will get additional bonus amounts after 12 or 18 months on the job.

The catch? And there always is one: Nothing is free.

In the case of EFLs, the bonus payments are made in the form of forgivable loans over a period of years and are secured by ironclad promissory notes. If, before the end of that period, a broker leaves or is fired for cause (which is often defined as low production in the EFL documents, unless the broker's attorney has deleted that from a draft of the forgivable loan), typically any unforgiven portion must be repaid immediately (and most are only forgiven on an annual and not monthly basis) Sometimes EFLs provide if the broker is fired without cause, the unforgiven portion is accelerated and forgiven upon

termination. But then the broker must report that balance on his or her tax return as income earned that year, not being able to spread it over the life of the loan.

Although the terms of EFLs vary somewhat from firm to firm, they are in concept similar and have been refined by the firms to a mathematical science. Firms make detailed financial assumptions about a broker's productivity in extending these loans and notwithstanding the amounts, the firms fully expect to make money on the deal in the form of commissions charged to clients.

If a broker leaves one firm for another, he may well get a replacement EFL, which takes into account the amount he needs to repay his prior firm. For, a broker who leaves or is fired and has a note that does not have an acceleration clause or cannot get a replacement EFL, the financial consequences can be overwhelmingly bad.

In a perfect world, the broker will save enough of the money provided under the EFL to repay any unforgiven amounts. But brokers are people too. The reality is that this seems to happen rarely. Frequently, the broker spends or invests the money upon receipt, at time of employment, and when it comes time to repay, he doesn't have the funds to satisfy his obligations under the governing promissory note. The firm will then start, and usually win, a case to enforce a broker's obligation under the EFL.

There are hundreds of FINRA cases every year where arbitration panels award firms the full amount of the outstanding note balances, plus interest, and sometimes legal fees (promissory notes often including fee shifting clauses, although arbitrators appear to

be more reluctant to enforce them; it is not uncommon to see Awards with tens or even hundreds of thousands of dollars in legal fees assessed against the defaulting broker). Brokers often appear *pro se* in these cases, or not at all, and seem to lose 99.99% of the time. It's a grim legal landscapefrom a broker's point of view. Most of the time, that is.

There is another side. Brokers are not without some recourse. Often firms will negotiate reductions in the amount due and reschedule the payment terms. No matter how heartless they are, the firms would prefer to get some money back instead of nothing. And their biggest fear is not losing a case; it is winning a case and finding the broker then filing for bankruptcy protection.

Brokers claiming financial hardship can secure such a resolution so long as they provide detailed financial statements establishing financial distress. Firms will rarely respond to emotional or argumentative pleas, but will respond to a financial statement that shows that it will be unrealistic if not impossible for it to make a full recovery.

Many brokers never elect to pursue this kind of negotiated outcome, however, and instead hope blindly that a FINRA arbitration panel will cancel their obligations under the EFL. This strategy, unsurprisingly, virtually never succeeds.

Sometimes, though, there is a case where it is worthwhile for a broker to fight. To put it in the broadest generalization possible, one might call these cases: "situations where firms do something that harms the broker and the broker had nothing to do with

it." To the extent that arbitrators will use their equitable powers to invalidate the promissory notes, it is in these situations where it is most likely to happen. But even then you need an arbitrator who believes that arbitration is a forum of equity.

For instance, in their zeal to recruit brokers and meet recruiting goals, recruiting managers make promises that they don't have the authority to make, but make them anyway to seal the deal. In one case from 2013 in which I represented the broker,[1] The Wall Street Journal[2] reported:

> An arbitration panel has rejected Morgan Stanley's $1.1 million claim against an ex-broker who failed to repay a signing bonus. Morgan Stanley claimed the broker, Barney Greengrass, owed roughly $940,550 plus interest because he left the firm before fulfilling the terms of the bonus, according to the ruling from the Financial Industry Regulatory Authority arbitration panel. As is typical, the bonus was given in the form of a loan, or promissory note, to be gradually forgiven over a number of years.
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> It is unusual for a brokerage to lose a promissory note claim, but Mr. Greengrass charged that Morgan Stanley broke a promise to him when it hired him in 2005. In a counterclaim, he said a branch manager promised him that his big institutional accounts would be provided with the same preferential margin interest rates and margin collateral levels they enjoyed while at his former employer, Smith Barney, according to his lawyer, Ethan Brecher.
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> When he arrived at Morgan Stanley, however, that was not the case. This upset some of his clients, including his biggest, well-known investor Carl Icahn, who pulled a $20 million account that had generated $350,000 in annual production because it was heavily traded, Mr. Brecher said. Some other important clients left, too.

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[1] See Morgan Stanley v. Barney Greengrass, FINRA Case # 10-05731 (Mar. 15, 2013).

[2] http://online.wsj.com/news/articles/SB10001424127887324323904578368864157899582 (March 18, 2013)

> Mr. Greengrass managed about $325 million in assets with a yearly production of roughly $2.5 million when he joined Morgan Stanley, his lawyer said. Because of his dissatisfaction with his new employer, he returned to Smith Barney in 2008. Soon after, Morgan Stanley and Smith Barney coincidentally merged operations in a joint venture with Smith Barney's owner, Citigroup, Mr. Greengrass later left to join JP Morgan Securities, where he now works.
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> Morgan Stanley filed its arbitration claim against Mr. Greengrass in December 2010, and he filed his counterclaim in April 2011, asking for more than $2 million in damages. The arbitration panel denied both the claim and the counterclaim, lifting Mr. Greengrass's obligation to repay the bonus but denying him any damages. "We think it's a tremendous victory and vindicates Barney's view" that he was made false promises when moving to Morgan Stanley, according to Mr. Brecher.

As is typical, the arbitration panel in that case provided no explanation for its decision, but it clearly accepted the fundamental point the broker was making: that he had been made promises which the firm failed to honor, promises that when broken cost the broker a significant amount of money. The result suggests that firms cannot expect to engage in misrepresentations in their recruitment of brokers and then also successfully enforce the contractual obligations in the EFLs when the broker has been harmed in relying on promises in the recruiting process.

Another instance where a firm lost an EFL case involved Lehman Brothers' attempt to reclaim EFL monies from a broker.[3] He undoubtedly won his case because his business was harmed as a consequence of Lehman Brothers' bankruptcy, for which he had no responsibility. (Interestingly, the trustee administering Lehman Brothers' bankrupt estate won many but not all of the firm's EFL cases, which only goes to show

[3] See Lehman Brothers v. Sloan, FINRA Case # 11-01774 (Oct. 17, 2012).

the somewhat random nature of the arbitration process where similarly situate individuals get treated differently.)

So, while the vast majority of EFL cases get decided in the firms' favor, in some cases the brokers win, with arbitrators exercising equitable powers or giving close attention to a fact pattern that would justify forgiveness under the EFL's express terms.

EFL cases are hard to resolve because they involve financial pain for the broker, despite a successful negotiation. Even if a broker can negotiate a reduction in the amount of indebtedness, that reduction becomes a taxable event. Thus, the broker has the Hobson's choice of paying the firm back or paying taxes to the IRS. Further, a broker might have taken the money from the EFL and made a bad investment, for example in real estate. The money becomes illiquid and even if he wanted to repay he cannot because he cannot access the funds.

For the lawyer representing a broker in an EFL case, the temptation is to assert counterclaims to try and level the playing field and hope for an affirmative recovery or an offset. This strategy, which will undoubtedly prolong the litigation, far more often than not fails and the broker is required to repay the EFL, plus interest and attorney's fees. Indeed, the counterclaim strategy frequently looks like something contrived to deflect the EFL claim, rather than a substantial claim. However, if the broker's "counterclaim" is filed before the firm's claim, it may be given greater weight by the arbitrators and not look like a reactive, knee-jerk reaction.

Recently, in a FINRA arbitration, Barclays won $3,250,000 on an EFL claim against an employee who asserted a variety of counterclaims totaling nearly $4 million. The case was tried before a FINRA arbitration panel over 15 days (28 hearing sessions in total) and Barclays won its claim with interest, while the broker made no recovery on his counterclaims. He was also saddled with 50% of the forum fees, which totaled $37,200.[4] According to the *Securities Arbitration Commentator's* ARBchek Update UA 2014-05, this was the "highest such award in two and a half years and the third highest since we began keeping track."

This result, although large, is not surprising, because EFLs are simple contracts and, generally speaking, FINRA arbitrators will enforce these contractual arrangements. It is the dark underside of the EFL bait. The EFL can become an expensive financial trap from which the only escape might be bankruptcy.

In sum, the EFL needle-in-the-haystack-case from the broker's perspective is one where the he has compelling evidence that the firm engaged in some form of misconduct (such as a recruiting misrepresentation), for which the broker should not be held accountable. Recruiting managers are under significant pressure to hire brokers. The human element cannot be ignored, and the fact that managers might say what they have to say to get a deal done is a real possibility, even if untrue.

[4] See Barclays v. McSwain, FINRA # 12-00601 (Jan. 16, 2014).

Neither a broker nor his counsel should be under any illusions, however, that an EFL arbitration will turn out well for the broker. They almost never do. But the broker is not powerless to mitigate the harm from repaying an EFL, and occasionally has the ability to defeat a claim completely if he can show that the firm harmed him, or at least negotiate a better deal. It's not easy, but it's not impossible, either.