To W-2 Or 1099, That Is The Question

Law360, New York (September 07, 2012, 11:50 AM ET) -- In a decision of significance to the broker-dealer industry, on Aug. 20, 2012, in Taylor & Young v. Waddell & Reed, et al., the Southern District of California granted summary judgment in favor of the independent broker-dealer firm, finding that its financial advisers were properly classified as independent contractors and not entitled to relief under California's Labor Code, which applies only to employees.

This case concerns the claims of Kenneth Young and Michael E. Taylor, two former financial advisers who sold financial products and services on behalf of Waddell & Reed (W&R). At issue was whether the financial advisers were employees under the common law test of employment set forth in S.G. Borello & Sons Inc. v. Department of Industrial Relations, 48 Cal. 3d 34 (1989).

Under Borello, the "principle test of an employment relationship is "[w]hether the person to whom service is rendered has the right and manner to control the manner and means of accomplishing the results desired." Id. at 350. Additional factors recognized by Borello are:

> (1) whether the person performing services is engaged in an occupation or business distinct from that of the principal; (2) whether or not the work is a part of the regular business of the principal or alleged employer; (3) whether the principal or the worker supplies the instrumentalities, tools, and the place for the person doing the work; (4) the alleged employee's investment in the equipment or materials required by his or her task or his or her employment of helpers; (5) whether the service rendered requires a special skill; (6) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision; (7) the alleged employee's opportunity for profit or loss depending on his or her managerial skill; (8) the length of time for which the services are to be performed; (9) the degree of permanence of the working relationship; (10) The method of payment, whether by time or by the job; and (11) whether or not the parties believe they are creating an employer-employee relationship.

Maintaining that they should have been classified as employees, plaintiffs focused on the level of control exercised by W&R. They argued that they were employed at-will, prohibited from

working as a licensed agent for any other broker-dealer, required to sell exclusively W&R's investment products, obligated to submit quarterly reports and to adhere to W&R's policy and procedures manual, which sought not only to meet all regulatory requirements but to exceed them.

Regulatory requirements included, among other things, the broker-dealer maintaining written procedures reasonably designed to achieve compliance by the registered representatives, closely monitoring the financial advisers' actions including reviewing outgoing correspondence as well as advertisements and solicitations, ensuring that public displays of a registered representative's name and business functions identify a broker-dealer, monitoring financial advisers' activities to ensure they are properly licensed and qualified and overseeing a continuing education program, and routinely auditing their advisers to ensure suitability, among other things.

W&R explained that the regulatory control it exercises over its financial advisers is mandated by the Financial Industry Regulatory Authority and U.S. Securities and Exchange Commission requirements and does not evidence an employment relationship.

In an amicus brief filed in the case, the Financial Services Institute Inc. (FSI), an advocacy and membership organization for broker-dealers and financial advisers, emphasized that the Taxpayers Relief Act of 1997 makes it dispositive that "no weight" is to be given to regulations mandated by the government or a governing body pursuant to delegation by a federal or state agency. FSI strongly argued that any alteration to such principles stated in the act would have "seismic impacts on the retail securities business" that should only be attempted through the legislative process and not court.

In support of its independent contractor classification, W&R explained that its advisers signed professional career agreements attesting to their independent contractor status and acknowledging that they would "exercise [their] own judgment as to the persons whom [they would] solicit and the time, place and manner of solicitation."

Moreover, plaintiffs were paid commissions based on sales, developed their own business models and strategies, were licensed, and determined how much they would charge for their services (subject to legal requirements), whether they would work at W&R's offices and whether they would hire assistants.

W&R further argued that its relationship with their registered representatives was "strikingly similar"to Mutual of Omaha's relationship with its insurance agents in Arnold v. Mut. of Omaha, 202 Cal. App. 4th 580, 586 (2011). On Dec. 31, 2011, the California Court of Appeal affirmed summary judgment holding that Mutual of Omaha's insurance agents were independent contractors.

The California Court of Appeal emphasized that even though some of the Borello factors pointed to an employment relationship, "all of the factors weighed and considered as a whole establish that Arnold was an independent contractor and not an employee." Id. at 590.

In particular, the California state court was persuaded by Arnold's freedom to exercise her own judgment regarding the clients she would solicit and the time, place and manner, and amount of such solicitation. The Southern District found W&R's argument persuasive; "Arnold appears to be analogous, since W&R's relationship with the Advisors share many of the same characteristics of Mutual of Omaha's relationship with its insurance agents in that case."

According to FSI's brief, more than 60 percent of all practicing financial advisers operate as self-employed independent contractors associated with independent broker dealer firms and "serve

a large portion of middle class investors." This decision affirms the nature of the relationship between independent broker dealers, who make up a significant part of the retail securities industry, and their advisers.

The court's holding that the W&R financial advisers were properly classified as independent contractors should deter future claims by registered representatives seeking damages for overtime, meal and rest period violations, reimbursement of business expenses, and penalties for failure to provide wage statements.

This decision is also significant as it held that California Senate Bill 459, which went into effect on Jan. 1, 2012, is not retroactive. The Southern District of California denied the plaintiffs' motion to amend the complaint to add a new plaintiff who worked until September 2011 and sought to assert Private Attorney General Act claims under Labor Code section 226.8.

Section 226.8 was added to the California Labor code as part of Senate Bill 459 and allows penalties of between $5,000 and $15,000 for each violation or $10,000 to $25,000 for each violation if an employer is found to have engaged in a pattern and practice of violations.

Senate Bill 459 also requires employers who are found to have misclassified employees "to display prominently" on their Internet Web sites for one-year a notice to employees and the general public announcing that the employer "has committed a serious violation of law by engaging in willful misclassification of employees." Significant lobbying efforts by the financial services industry resulted in amendments to the bill removing other burdensome notice and record-keeping requirements for all independent contractors in California.

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