SUPERIOR COURT OF CALIFORNIA, COUNTY OF ORANGE Civil Complex Center 751 W. Santa Ana Blvd Santa Ana, CA 92701	
SHORT TITLE: Chen vs. Morgan Stanley Smith Barney LLC	
CLERK'S CERTIFICATE OF MAILING/ELECTRONIC SERVICE	CASE NUMBER: **30-2014-00724866-CU-OE-CXC**

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SUPERIOR COURT OF CALIFORNIA,
COUNTY OF ORANGE
CIVIL COMPLEX CENTER

MINUTE ORDER

DATE: 08/31/2017 TIME: 03:49:00 PM DEPT: CX102

JUDICIAL OFFICER PRESIDING: William Claster
CLERK: Gus Hernandez
REPORTER/ERM: None
BAILIFF/COURT ATTENDANT: None

CASE NO: **30-2014-00724866-CU-OE-CXC** CASE INIT.DATE: 05/27/2014
CASE TITLE: **Chen vs. Morgan Stanley Smith Barney LLC**
CASE CATEGORY: Civil - Unlimited CASE TYPE: Other employment

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EVENT TYPE: Chambers Work

APPEARANCES

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1) Plaintiff Tracy Chen's Motion for Summary Adjudication
2) Defendant Morgan Stanley Smith Barney LLC's Motion for Summary Adjudication

There are no appearances by any party.

The Court, having taken the above-entitled matters under submission on 8/25/2017 and having fully considered the arguments of all parties, both written and oral, as well as the evidence presented, now rules in accordance with the ruling attached hereto and incorporated herein.

Court orders clerk to give notice.

Overview

Defendant Morgan Stanley Smith Barney, LLC's ("Morgan Stanley") Automated Flexible Grid, subsequently renamed Alternative Flexible Grid, is at the center of the company's business model. Rather than determining what amounts a Financial Advisor ("Advisor") should be allocated for expenditures beyond those covered by a basic business development allowance—including expenditures such as client entertainment, marketing and additional support staff—Morgan Stanley allows Advisors to participate in the Automated/Alternative Flexible Grid ("AFG") program and make those determinations on their own. The upshot of this program is that each Advisor essentially is given significant freedom to run his or her own individual business. Thus, even though the Advisors are Morgan Stanley employees, they can decide where to allocate resources, including the amount, if any, of bonuses paid to their assigned Client Service Associates ("CSA"), and whether to have Morgan Stanley hire and pay (using AFG funds) additional support staff.

The AFG funds used to pay for these expenditures, as well as a portion of the overhead associated with the supplemental support staff, are derived from a lowered commission rate paid to the Advisor. Stated simply (and the program is anything but simple), the more AFG funds an Advisor allocates for extra items such as CSA bonuses or supplemental staff, the lower the commission rate. It appears that the purpose of the lowered commission rate is to approximate a dollar-for-dollar reduction of the cost of the estimated extra items from the estimated total annual commissions. An example of this trade-off is found in the Joint Stipulated Facts where a hypothetical Advisor who desires approximately $37,000 in AFG funding has his advance commission grid rate reduced from about 41% to 35.9%, which equates to about a $37,000 reduction in anticipated total commissions for that year. (ROA 608, Joint Stipulated Facts ["JSF"] 120-121.) Presumably, the Advisor who agrees to this trade-off believes that the additional funding will result in an increase in revenue (and, therefore, more compensation for the Advisor) sufficient to outweigh the reduced commission rate.

Before the Court are the parties' cross-motions for summary adjudication of issues regarding whether the AFG program comports with Labor Code sections 221, 402-405, and 2802. (All subsequent statutory references are to the Labor Code, unless expressly noted otherwise.) Although the parties raise similar, overlapping issues (e.g., validity under Section 221), they are not precisely the same. The key issue in these motions is whether Morgan Stanley violates these Labor Code provisions when it reduces an Advisor's commission rate to pay all or part of another Morgan Stanley employee's compensation. Indeed, as set forth in the Joint Stipulated Facts, 70% of total AFG expenditures goes to supplemental support staff compensation. (ROA 608, JSF 132.) For the reasons stated below, both motions are DENIED.

Chen's Motion for Summary Adjudication

Plaintiff Tracy Chen's ("Chen") first issue seeks summary adjudication that the "AFG [program] effects wage deductions not authorized by statute, in violation of California Labor Code §221." (ROA 575, all caps in original.) She argues that because AFG deductions are made to pay expenses that must be absorbed by Morgan Stanley under LC § 2802 as a matter of law, AFG achieves illegal wage deductions regardless of whether the deductions are factored "above the line." Furthermore, she contends that Morgan Stanley cannot legally defer the accrual of earned commissions for the purpose of deducting expenses simply by calling them "advances."

Chen's second issue for summary adjudication is as follows: "By funding expense 'reimbursement' with amounts that otherwise would be paid to financial advisors as wages, AFG is tantamount to a refusal to reimburse business expenses, in violation of Cal. Lab. Code §2802." (ROA 575, all caps in original.)

Thus, as framed by Chen, the first issue for summary adjudication of the Section 221 claim necessarily depends on whether she can prevail on the second issue for summary adjudication of her Section 2802 claim.

Section 2802(a) provides that "[a]n employer shall indemnify his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful." "The elements of a claim under Section 2802 are: (i) the employee made expenditures or incurred losses; (ii) the expenditures or losses were incurred in direct consequence of the employee's discharge of his or her duties, or obedience to the directions of the employer; and (iii) the expenditures or losses were reasonable and necessary. *See Gattuso v. Harte–Hanks Shoppers, Inc.,* 42 Cal.4th 554, 568, 67 Cal.Rptr.3d 468, 169 P.3d 889 (2007)." (*Marr v. Bank of America* (N.D. Cal. 2011) 2011 WL 845914, at *1.)

Here, there is at triable issue of material fact as to whether the expenditures in question were reasonable and necessary. "Section 2802(c) provides that '[f]or purposes of this section, the term "necessary expenditures or losses" shall include all reasonable costs, including, but not limited to, attorney's fees incurred by the employee enforcing the rights granted by this section.' California courts have found that '[n]ecessity is by nature a question of fact' and that "the reasonableness of any given expenditure must turn on its own facts.' Consequently, summary judgment on the question of whether an expenditure is necessary for the purposes of section 2802 is only appropriate where the facts are undisputed and no conflicting inferences are possible." (*Nguyen v. Wells Fargo Bank* (N.D. Cal. 2016) 2016 WL 5390245, at *9.)

In this case, although Chen contends all expenses under the AFG program are necessary and reasonable, her argument is limited to support staff compensation, which includes additional bonuses paid to CSAs and base salaries and bonuses

paid to additional support staff. Although there are a number of other AFG expense categories, such as client entertainment (including dinners, event tickets, and gifts), office supplies, mailing and postage, marketing materials, and IT items (including blackberries) (ROA 608 at p. 55-56, 61-64, 68-70, 231-246, 260, 405-419), these other expenses are not the subject of Chen's motion and therefore are not addressed here.

At least one appellate court has noted that salaries or compensation other staff "appear on their face to be for standard business expenses, not chargeable to an employee, even a commissioned sales employee. ... A DLSE opinion letter addressing whether the expense of hiring an assistant could be charged to an insurance company's commissioned sales manager explains why such expenses are not transferable: '[Labor Code provisions] announce the long-standing policy of the State of California in regard to an employer's obligation to pay all costs his employee expends or loses in carrying out the duties of the employment. The employment of more help to either sell insurance or help with the paperwork so that others would be free to sell more insurance is ... a "direct consequence of the discharge of [the manager's] duties." [¶] As is clear from the [Labor Code], under the California law, an employer may not "pass through" the normal costs of operating a business to the employee he hires. Debiting an employee's earned wages to cover a normal operating expense of the employer is not allowed in California.' (DLSE Opn. Letter No.2000.08.01 (Aug. 1, 2000), at p. 4.) Stated succinctly: 'It would appear to be axiomatic that any increase in the amount of legitimate sales made by an agent of an insurance company would normally be expected to result in an increase in the profits of the company' and therefore, 'inure to the benefit of [the company].' (*Id.* at p. 3.)" (*Davis v. Farmers Insurance Exchange* (2016) 245 Cal.App.4th 1302, 1336-37.)

Under Section 221, "the employer bears the burden of establishing that such deductions are authorized by law." (*Id.* at 1337.) In this case, Plaintiff points to the fact that Morgan Stanley treats AFG as an accountable expense reimbursement for tax purposes and must be approved by a manager as reasonable and necessary. (ROA 608, JSF 73, 74, 86, 90.) Also, there is evidence that the greatest

revenue generating Advisors pay support staff compensation. (ROA 608, JSF 132; ROA 646, Chen's UMF 5-6.) For these reasons, Chen has met her initial burden of showing that compensation for supplemental support staff is a general operating cost to be borne by Morgan Stanley.

Morgan Stanley, on the other hand, has presented evidence that some Advisors do not consider support staff compensation to be a necessary expenditure. (ROA 646, Additional UMF 22, 34.) The conflicting evidence as to whether staff support compensation paid by Advisors is reasonable and necessary, rather than discretionary and optional, precludes summary adjudication on this issue. As in *Nguyen v. Wells Fargo Bank, supra*, the evidence before the Court at this time does not lead to a single conclusion on this issue.

Finally, although Chen's motion papers include a brief argument as to why the AFG program violates Sections 402-405 (ROA 573, p. 20), her moving separate statement contains only two issues for summary adjudication, neither of which concerns California's bond laws (ROA 575). To the extent Chen seeks summary adjudication with respect to her Section 402-405 claims, the motion is denied for failure to comply with CCP § 437c(b)(1).

<u>Morgan Stanley's Motion for Summary Adjudication</u>

Morgan Stanley's first issue seeks summary adjudication that Chen's "Section 221 deductions claim fails because the AFG program does not cause a deduction from earned wages, and even if it did cause a deduction, it would be permissible." (ROA 605, p. 1:11-13.) According to Morgan Stanley, every December an Advisor chooses whether to participate in the AFG program for the next year at a specified commission rate and Morgan Stanley agrees to pay that rate—all before any commission is earned by the Advisor for that next year. It contends, under these facts, there is no deduction from the Advisor's earned wages. Even if there were a deduction, it is lawful because the Advisor voluntarily agreed in writing to

the deduction and to the fact that such expenses are tied to his or her sales, rather than generalized business expenses.

The Court finds that triable issues of material fact exist as to three interrelated questions: (1) when an Advisor's incentive compensation or commission is earned; (2) whether AFG credit rate adjustments that are made to allocate funds to pay for staff compensation constitutes an unlawful deduction under Section 2802; and (3) whether a deduction for staff compensation is first taken after the Advisor makes the election to participate in the AFG program and also when the Advisor begins receiving commission payments or advances during the AFG Checkpoint, or at the year-end calculation of the final incentive compensation grid rate.

Section 221 provides that "[i]t shall be unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee." It "was adopted to prevent the use of secret deductions or 'kickbacks' to make it appear the employer is paying a required or promised wage, when in fact it is paying less." (*Prachasaisoradej v. Ralphs Grocery Co., Inc.* (2007) 42 Cal.4th 217, 231.)

"[A]n employee's 'wages' or 'earnings' are the amount the employer *has offered or promised to pay*, or *has paid pursuant to such an offer or promise*, as compensation for that employee's labor. The employer takes a 'deduction' or 'contribution' from an employee's 'wages' or 'earnings' when it subtracts, withholds, sets off, or requires the employee to return, a portion of the *compensation* offered, promised, or paid as offered or promised, so that the employee, having performed the labor, actually receives or retains less than the *paid, offered, or promised compensation*, and effectively makes a forced 'contribution' of the difference." (*Id.* at 228 [underlining added].) "One of the circumstances allowing wage deductions is that an employer may recover a commission that was an 'advance' but not yet 'earned.' Generally, the right to a commission depends on the terms of the parties' contract." (*Sciborski v. Pacific*

Bell Directory (2012) 205 Cal.App.4th 1152, 1166 [internal citations and some quotes omitted].)

Thus, to determine whether the AFG program causes a deduction from earned wages, it must first be determined when the Advisor's commissions are earned. "A commission is earned when the employee has perfected the right to payment; that is, when all of the *legal* conditions precedent have been met. Such conditions precedent are a matter of contract between the employer and employee, subject to various limitations imposed by common law or statute. [¶] Because a commission is not earned until the express contractual conditions are met, Labor Code section 221 does not prohibit an employer from recouping the advance if the conditions are not satisfied. However, once the express contractual conditions are satisfied, the commission is considered a wage and an employer cannot recoup the commission once it has been paid to the employee." (*Sciborski v. Pacific Bell Directory* (2012) 205 Cal.App.4th 1152, 1166-1167 [internal citations and quotes omitted].)

"Because of the strong public policy protecting wages, an employer's right to recoup an advance commission generally requires a showing that the employee agreed in writing to the specific condition and to the employer's right to recoup the advance under the stated conditions. ... [¶] Additionally, an employer's right to define an 'earned' commission in the employment contract is not unlimited. Generally, '[t]he essence of an advance is that at the time of payment the employer cannot determine whether the commission will eventually be earned because a condition to the employee's right to the commission has yet to occur or its occurrence as yet is otherwise unascertainable.' Thus, for example, an employer may expressly condition an earned sales commission on the sale becoming final (e.g., no returns within a specified time or final payment received) or on the employee completing work in providing follow up services to the customer. But an employer may not require an employee to agree to a wage deduction in the guise of recouping an advance based on conditions that are unrelated to the sale and/or that merely reflect the employer's attempt to shift the cost of doing business to an employee. ... An employer is not entitled to

'require[ ] its employees to consent to unlawful deductions from their wages.'" (*Id.* at 1167-1168 [internal citations omitted].)

In summary, "employers and employees may agree that an employee must satisfy certain conditions before earning a sales commission and an employer may recoup an advance if these conditions are not satisfied. However, to rely on those conditions as a basis for recouping an advance paid for a commission, the condition must be clearly expressed and generally must be set forth in writing. Additionally, the conditions must relate to the sale and cannot merely serve as a basis to shift the employer's cost of doing business to the employee." (*Id.* at 1171.)

In this case, Morgan Stanley argues that "[b]ecause incentive compensation is calculated based on a Financial Advisor's annual revenue, it can only be calculated and is only earned at the end of the year. JSF 40. Until then, Morgan Stanley provides Financial Advisors with monthly incentive compensation advances" (ROA 604, p. 5:8-10), which are later adjusted if those "advances" exceed what the Advisor actually earned under the compensation plan (ROA 608, JSF 42).

Even though Morgan Stanley's written compensation plan states that commissions are only earned at the end of the year and characterizes the monthly commissions paid as "advances," there is a triable issue of material fact whether an Advisor's commissions are earned before the end of the year, notwithstanding the fact that the exact dollar figure cannot be determined until the end of the year. Morgan Stanley's condition precedent to an Advisor "earning" commissions (i.e. waiting until the end of the year to ascertain the FA's annual revenue to be used in calculating the actual commission rate) does not appear to bear any relation to the fact of the Advisor's sales. For example, there does not appear to be any dispute that if an Advisor generates fees to be paid to Morgan Stanley in January 2013, at some point well before December 2013 the Advisor will be entitled to incentive compensation based on the January 2013 revenue (such that he or she can be said to have earned the incentive

compensation); the only uncertainty is what credit grid rate will apply for purposes of calculating the dollar amount of the commission earned.

Because the foregoing condition (waiting until year end to lock down the final commission rate) does not appear to relate to the Advisor's sales, the question remains whether it "merely serve[s] as a basis to shift the employer's cost of doing business to the employee." (*Sciborski v. Pacific Bell Directory, supra,* 205 Cal.App.4th at 1171.) Here, for the reasons stated in the Court's ruling on Chen's motion for summary adjudication, there is a triable issue of material fact as to whether or not supplemental support staff compensation is a general business expense and therefore whether or not it is an allowable deduction. If it is <u>not</u> an allowable deduction, then it would appear to violate Section 221 depending on when the commissions are in fact earned.

As noted previously, "[t]he employer takes a 'deduction' or 'contribution' from an employee's 'wages' or 'earnings' when it subtracts, withholds, sets off, or requires the employee to return, a portion of the *compensation* offered, promised, or paid as offered or promised, so that the employee, having performed the labor, actually receives or retains less than the *paid, offered, or promised compensation,* and effectively makes a forced 'contribution' of the difference." (*Prachasaisoradej v. Ralphs Grocery Co., Inc., supra,* 42 Cal.4th at 228.) If use of AFG funds for staff compensation is not an allowable deduction and an Advisor's commissions are indeed earned before the end of the year, then the only remaining triable issue is when the unlawful deduction first occurs. Thus, if the Advisor's entitlement to a commission—as opposed to entitlement to the exact dollar amount of the commission—exists when the commission payments or advances are made, then an unlawful deduction would appear to occur when the Advisor is paid her first commission of the year and the amount representing the difference between her baseline commission and the AFG credit rate adjustment is set aside in an AFG "pool" to be used to pay for support staff compensation.

Moreover, whether or not support staff compensation is an allowable deduction, if there is a forced change to the Advisor's AFG election rate at the AFG Checkpoint, "a mid-year opportunity to make [an] adjustment" to the level of an Advisor's participation in the AFG program (ROA 608, JSF 100), then there is a triable issue of material fact whether such a change constitutes an unlawful deduction from the Advisor's earned wages. Consider the following hypothetical for illustration purposes only (the precise amounts, percentages, and rates do not match up with any AFG program year):

In December 2012, an Advisor decides to participate in the AFG program for the upcoming 2013 year. To do so, she has to predict how much in total 2013 annual revenue she will generate for Morgan Stanley and how much in 2013 annual expenses she will seek reimbursement for under the AFG program. In 2012 she generated $500,000 in creditable revenue. She predicts that she will generate the same revenue amount in 2013 and that her AFG reimbursable expenses, all for supplemental support staff compensation, will be $24,000 ($2,000 monthly).

For the Advisor, $250,000 to $500,000 in creditable annual revenue would result in a 30% unadjusted commission rate and an anticipated commission of $150,000 (30% of $500,000) for 2013. Because she participates in the AFG program so that she can be reimbursed for $24,000 in expenses, her forecasted AFG credit rate adjustment is 4.8% and her forecasted adjusted commission rate is lowered from 30% to 25.2%. Assuming there is $500,000 in creditable annual revenue at the end of 2013, the Advisor's participation in the AFG program will result in her receiving $126,000 in commissions (25.2% of $500,000) and $24,000 in reimbursements for AFG expenses (4.8% of $500,000). Because the Advisor makes the decision to participate in the AFG program in December 2012 for revenue to be made in 2013, Morgan Stanley correctly notes that the Advisor has not earned any commission or wages when she elects to participate in the AFG program. Moreover, the Advisor's actual commission rate is not final until December 2013.

In January 2013 the Advisor generates $200,000 in revenue, but from February through June she generates nothing. During this time she has accrued $12,000 in AFG expenses (supplemental support staff for January – June), but she has only funded $9,600 into her AFG "pool" (4.8% x $200,000). It is now forecasted that she will generate $300,000 in creditable annual revenue, instead of $500,000, for the year. At the July 2013 AFG Checkpoint, the Advisor adjusts her participation level to reflect a forecasted AFG credit rate adjustment of 6.7% and a forecasted adjusted commission rate of 23.3%, rather than forego help from supplemental support staff.

By December 2013, the Advisor has generated only $280,000 in revenue for the year and has $24,000 in AFG expenses. Because of the mid-year adjustment of the commission rate from 25.2% to 23.3%, the employee receives commissions of $65,240 instead of $70,560 for the year.

In the foregoing hypothetical, if the Advisor's right to a commission is deemed earned before December 2013, the question is whether the commission rate adjustment at July 2013 AFG Checkpoint constitutes an unlawful deduction from wages. Although the AFG Checkpoint is characterized as a "mid-year opportunity to make [an] adjustment" to commission rate (ROA 608, JSF 100), there is evidence that suggests that an Advisor who is running a deficit in AFG funds has no choice but to increase her AFG credit rate adjustment (thereby decreasing her commission rate) to eliminate the deficit. Exh. M to the Joint Stipulation of Facts is an excerpt of Morgan Stanley's Compensation AFG Checkpoint policy for 2014 for the management responsible to approve AFG elections. It provides in relevant part:

- "The AFG Checkpoint is a one-time opportunity for AFG participants to review and revise their balance of the year forecasted expenses and Credit Rate Adjustment in order to assure that they do not end the year with an AFG surplus or deficit funding. [¶¶] At the August Checkpoint, **Financial Advisors who are in a deficit are required to increase their AFG Credit Rate Adjustment.**" (JSF p. 267; emphasis in original.)

- Approvers must "[r]**eview all FAs in a deficit. All FAs in a deficit are required to increase AFG Credit Rate Adjustment.** If the review is not properly completed and the AFG Credit Rate is insufficient to cover YE expenses, the funding will not be available for Supplemental Support Compensation and Luxury Items." (Id. at p. 281; emphasis in original.)
- "Best Practices" include "[m]ak[ing] sure FAs are properly allocating funds **to avoid deficits or remaining balances at year-end.**" (Id. at p. 290; emphasis in original.)

Even if an Advisor's December 2012 decision to participate in the AFG program were voluntary, the foregoing guidelines suggest that a mid-year increase in the AFG credit rate adjustment is forced on the Advisor so that Morgan Stanley can attempt to recoup any expenses it paid through the AFG program but for which the Advisor did not have sufficient funds in her AFG "pool." Of course, this forced adjustment results in the reduction of the commission rate for all revenue for the year, which effectively serves as a deduction from the previously "agreed to" wages. Significantly, in the hypothetical the reduced rate/deduction is attributable to AFG payments being used for support staff compensation, a practice arguably violative of Section 221. (*Marr v. Bank of America, supra* at *6.)

Morgan Stanley's second issue for summary adjudication issue is as follows: "Plaintiff's Section 402-405 claims fail because the AFG program funds are not earned wages." For the reasons discussed above, there is a triable issue of material fact whether the funds allotted to the AFG program are earned wages.