CERTIFIED QUESTION FROM THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT DOCKET NO. 02-2528

New York Court of Appeals Docket 3 No. 96

Court of Appeals

of the

State of New York

TODD B. MARSH,

Appellant,

– against–

PRUDENTIAL SECURITIES INCORPORATED,

Respondent.

BRIEF OF THE SECURITIES INDUSTRY ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP
1285 Avenue of the Americas
New York, New York 10019-6064
212-373-3000

Attorneys for the Securities Industry Association
Amicus Curiae

BRAD S. KARP
DANIEL J. TOAL
DANIEL R. GARODNICK
Of Counsel

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PRELIMINARY STATEMENT

This case involves a challenge to an established form of incentive compensation that consistently has been upheld by the courts of this State (including this Court), is permitted under the governing statute, and has been endorsed by the Securities and Exchange Commission.

For more than half a century, employers in New York and elsewhere have used contingent incentive compensation to promote employee productivity and retention. The use of restricted stock and option plans, in particular, has become an increasingly popular method of attempting to align employee interests with those of the employer. Such compensation long has been a major component of executive remuneration. Moreover, the use of restricted stock and option plans for non-executive employees is widespread and growing. In point of fact, a recent study found that more than 11 million employees in the United States are covered by such long-term incentive stock plans.

In the securities industry, contingent incentive compensation serves a particularly vital function. Almost a decade ago, the SEC expressly endorsed the use of such compensation plans to address concerns about actual and potential conflicts of interest in the retail brokerage industry. In view of its potential to reduce turnover and increase broker accountability, the SEC identified the use of deferred and contingent compensation as a "best practice" for securities firms. The securities industry responded promptly to the SEC's expressed concerns, with many firms implementing incentive compensation plans of the precise type the SEC had endorsed. As a result, in a recent survey, nearly half of retail brokerage firms reported offering contingent equity compensation to their retail brokers.

In his suit against his former employer, Appellant Marsh contends that all of this has been in contravention of the New York Labor Law. Marsh argues that incentive compensation programs that permit employees to receive restricted stock in lieu of fixed compensation violate Section 193 of the Labor Law, which prohibits deductions from "wages" unless authorized in writing and for the benefit of the employee.

The law, however, is definitively to the contrary. The text of Article 6 of the Labor Law itself makes clear that incentive compensation, such as the restricted shares that Marsh received in Prudential's MasterShare Plan, does not qualify as "wages" within the meaning of the Labor Law. The statute defines "wages" as amounts that have been earned for services that already have been rendered. This definition necessarily excludes incentive compensation, which is not earned unless, and until, all conditions precedent to payment, including any vesting provisions, have been satisfied. As a result, the text of the Labor Law forecloses any claim that Appellant Marsh is entitled to receipt of his unvested MasterShare Plan shares.

An unbroken line of precedent in New York, including this Court's seminal decision in *Truelove* v. *Northeast Capital & Advisory, Inc.*, 95 N.Y.2d 220 (2000), also establishes that incentive compensation does not qualify as statutory wages. Indeed, this has been settled law for more than a quarter of a century. And although it has amended Article 6 at least sixteen times since 1980, the Legislature has never so much as suggested, let alone expressly stated, that it disagreed with the unanimous judicial view that the provisions of New York Labor Law governing payment of statutory "wages" do not apply to incentive compensation programs like MasterShare.

The argument that an employee's election to receive part of his compensation in the form of restricted stock effects an unlawful deduction from statutory wages is equally unavailing. By definition, amounts that have not yet been earned do not constitute "wages," within the meaning of New York Labor Law. As a result, nothing in Article 6 restricts the right of employers prospectively to establish compensation rates for their at-will employees. And since Prudential unquestionably had the right to reduce Appellant Marsh's commission rate on future transactions, it necessarily had the ability to offer him the option of receiving his future compensation entirely in the form of commissions or, in the alternative, through a combination of commissions (at a somewhat lower rate) and restricted stock.

And, in all events, MasterShare and other similar programs would comply with New York Labor Law even if, contrary to law and fact, they involved deductions from "wages" since Article 6 permits authorized deductions made for the benefit of the employee. As noted in the Third Circuit's Petition for Certification to this Court, Prudential developed the MasterShare Plan for the express purpose of permitting its employees to take advantage of Section 83(b) of the Internal Revenue Code, which permits taxes to be deferred on compensation that is subject to a substantial risk of forfeiture. In addition, Prudential permits its eligible employees to acquire restricted shares in its MasterShare Plan at a 25 percent discount to the market price. And to further ensure that authorized deductions are made only for those employees who consider these aspects of the Plan beneficial, Prudential makes participation in the MasterShare Plan entirely voluntary.

We therefore respectfully submit that this Court should hold that the forfeiture of incentive compensation pursuant to the express terms of a governing compensation agreement does not contravene Article 6 of the New York Labor Law and, in any event, that authorized deductions pursuant to incentive compensation plans like MasterShare, and similar plans used throughout the securities industry, are permissible under Section 193 of the Labor Law because they are made for the benefit of the employee.

BACKGROUND

Contingent Compensation Plans Like MasterShare Are Prevalent in the Securities Industry and Elsewhere

In the past few decades, employers increasingly have relied on contingent incentive compensation plans to promote employee productivity and encourage employee retention. Long-term incentives continue to be the largest component of CEO compensation, MERCER HUMAN RESOURCE CONSULTING, 2002 COMPENSATION SURVEY AND TRENDS, at 2 (May 2003), but the trend is no longer limited to top corporate officers.

Corporate use of stock option plans for non-executive employees is widespread and growing. By the year 2000, eleven million employees in the United States were covered by long-term incentive stock plans, *Compensation: U.S. Firms Lead in Use of Stock Options to Attract Key Employees, Study Finds*, DAILY LABOR REPORT, Oct. 26, 2000, and the percentage of large firms granting stock options to at least half of their employees increased from 17% in 1993 to 39% in 1999. John E. Core & Wayne R. Guay, *Stock Option Plans For Non-Executive Employees*, JOURNAL OF FIN. ECONOMICS, Aug. 2001, at 1 [hereinafter, "Core & Guay"]; *see also* Ruth Simon, *The Employee Guide to Restricted Stock*, WALL ST. J., Jul. 10, 2003, at D1 (noting that more than 60% of

companies surveyed in April 2003 indicated that they were either introducing restricted stock or expanding their use of it) [hereinafter, "Simon"].

The trend toward deferred compensation is even more pronounced in the securities industry, where 49% of companies surveyed reported offering stock options to their registered representatives in 2002, up from 44% in the previous year. Carmen Fernandez, *et al.*, SECURITIES INDUSTRY ASSOCIATION, PRODUCTION AND EARNINGS OF RRs 2002, at 4 (July 2003). Moreover, stock options were offered at almost 64% of securities firms with 100-1000 registered representatives, and at over 55% of firms with more than 1000 registered representatives. *Id.*

A typical feature of these deferred compensation programs is that employees forfeit their restricted stock or options if they leave the company before the stock vests. Simon, at D1; Paula H. Todd & Gary Locke, *Tax-Effective Approaches to Deferred Stock Compensation*, WORLDATWORK JOURNAL, Apr. 1, 2001 (explaining that restricted stock generally is forfeited if the employee resigns during a specified time period, usually ranging from three to five years) [hereinafter, "Todd & Locke"]. These vesting and forfeiture features are critical to promote employee retention. *See* Mark H. Edwards, *The Equity Economy: The Future Is Now*, WORLDATWORK JOURNAL, Apr. 1, 2001 (discussing role of restricted options in promoting heightened performance and employee retention); Core & Guay, at 1 (describing vesting periods as prevalent and noting that firms use options to retain employees).

Another common feature of these plans is the tax deferral of compensation received in the form of restricted stock. Contingent incentive compensation, such as restricted stock and options, provides a higher after-tax return — before adjusting for risk

— than an equivalent cash payment because taxes on such compensation are deferred until the risk of forfeiture lapses. *Id.*; *see also* 26 U.S.C. § 83(b). In addition, these programs offer benefits to employees because employers often subsidize their employees' participation in these plans in some form or fashion. *See, e.g.*, Regina T. Jefferson, Symposium, *Striking a Balance in the Cash Balance Plan Debate*, 49 BUFF. L. REV. 513, 528 (Spring/Summer 2001) (noting that, in the context of 401(k) contributions, an employer's matching contribution is designed to induce employees to invest in savings).

The SEC Has Determined That Stock Purchase and Deferred Compensation Plans Like MasterShare Represent the Securities Industry's Best Practices

For close to a decade, incentive compensation plans like the MasterShare Plan offered by Respondent Prudential Securities Inc. ("Prudential") have been endorsed as a "best practice" for compensation in the securities industry. In May 1994, in response to concerns about actual and potential conflicts of interest in the retail brokerage industry, SEC Chairman Arthur Levitt commissioned a broad-based Committee on Compensation Practices to propose optimal compensation practices for securities firms. SECURITIES & EXCH. COMM'N, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES, (Apr. 10, 1995), *available at* http://www.sec.gov/news/studies/bkrcomp.txt [hereinafter, "SEC, REPORT ON COMPENSATION PRACTICES"]. The Committee considered as "best practices" those compensation policies that were "designed to align the interest of all three parties in the relationship — the client, the registered representative, and the brokerage firm — and to encourage long-term relationships among them." *Id.* at 1.

The SEC specifically recommended that firms defer a portion of broker compensation for several years, and link payment to maintaining a clean compliance

record. *Id.* at 2. The SEC further suggested that securities firms use stock options or stock purchase plans as part of their compensation programs to align the interests of the employee with those of the firm and to reduce broker turnover. *Id.* The SEC thus expressly endorsed the notion that firms should "[u]se stock option or stock purchase plans in overall compensation programs," noting that "[t]hese plans are used by a number of firms to align the interests of employees with those of the firm" and that broker "turnover is presumably reduced and accountability increased through these programs." *Id.* at 11.

A number of securities firms have adopted such incentive compensation plans.[1] Prudential's MasterShare Plan, as an example, reflects "best practices" for compensation of retail brokers, as defined by the SEC, because it strengthens the connection between employee and firm, and provides a strong incentive for the broker to maintain a clean compliance record. MasterShare enables registered representatives to set aside between 5 and 25 percent of pretax earnings in a Prudential index fund that tracks the S&P 500. In addition, Prudential employees receive shares in this fund at a 25 percent discount to the market price, which means that Prudential effectively makes a 33⅓ percent

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[1] For example, along with Prudential, both Morgan Stanley and Citigroup have plans that offer similar incentives. Morgan Stanley has instituted a "Productivity Compensation Plan," which provides that in order to "retain and recruit key Account Executives," payment of any bonus award is to be deferred for five years and forfeited if the employee is no longer employed by the firm at the end of the five-year period. *See D'Amato* v. *Morgan Stanley Dean Witter Discover & Co.*, 701 N.Y.S. 2d 431 (1st Dep't 2000) (holding that that the award plaintiff sought to recover under the "Productivity Compensation Plan" did not constitute non-forfeitable "wages" within the meaning of Labor Law 190). Similarly, Citigroup's Capital Accumulation Plan ("CAP") is another bonus program that enables eligible employees to receive restricted stock as part of an annual incentive award, subject to a three-year vesting period. *Fallon* v. *Salomon Smith Barney*, No. 02-7500, 2003 WL 201321 (2d Cir. Jan. 30, 2003) (affirming district court's confirmation of arbitration award that held claimant's CAP restricted stock did not constitute "wages" within the meaning of New York Labor Law).

matching contribution on every dollar its employees elect to receive in the form of restricted stock. Participating Prudential employees also enjoy deferral of federal income tax on all amounts — including Prudential's contribution — that are awarded through MasterShare. In exchange, employees agree to a three-year vesting period, at the conclusion of which they receive their shares free from all restrictions.

Deferred Compensation Plans Like MasterShare Offer Substantial Benefits to Employees

Programs like MasterShare provide valuable benefits to securities brokers. The plans offer sophisticated financial professionals an opportunity to make potentially lucrative investments in equities, which have outperformed all other asset classes over time. Andy Serwer, *A New Theory on Relativity; Should Investors Question the Merits of Relative Performance in this Market? Absolutely*, FORTUNE MAGAZINE, May 12, 2003.[2] MasterShare, for example, allows eligible employees to invest in a Prudential Index Fund that tracks the S&P 500 index. The S&P index has increased approximately 11% per year since it was introduced in 1926. If history is any guide, participants in MasterShare will continue to see their equity investments appreciate substantially over time.

Deferred compensation plans like MasterShare also serve an important public policy goal of promoting employee savings. It is well established that deferred income is more likely to be saved. Elayne Robertson Demby, *Smaller Firms Consider A*

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[2] There has been a steady growth in equity ownership over time, and three-quarters of the liquid assets held by Americans today are in securities-related products. SECURITIES INDUSTRY ASSOCIATION, RECORD DEMAND FOR CAPITAL, STEADY RISE IN EQUITY OWNERSHIP, GLOBALIZATION FUELED SECURITIES INDUSTRY'S GROWTH (Nov. 7, 2002), *available at* http://www.sia.com/press/html/pr_record_demand.html. The total value of those assets has grown in value from $1.7 trillion in 1975 to $15.0 trillion by mid-2002. *Id.*

New Retirement Option: Compensation That Can Be Deferred into Savings Plans Helps Attract and Retain Key Executives, SOCIETY FOR HUMAN RESOURCE MANAGEMENT, July 1, 2003. As a result, as acknowledged by Lynn Dudley, vice president and senior counsel of the American Benefits Council: "[N]onqualified deferred compensation is vital to building retirement income for many thousands of U.S. employees including mid-level managers, salespeople, and other professional staff." News Release, *Nonqualified Deferred Compensation Plans Fuel Job, Corporate Growth Says Council Paper*, AMERICAN BENEFITS COUNCIL (Apr. 8, 2003).

The federal government itself repeatedly has recognized the important public policy supporting compensation plans that encourage savings. For example, the U.S. Treasury Department has, for nearly 100 years, confirmed the tax-deductibility of pension payments made by employees. Generally, "this favorable tax treatment of pension plans, and the similar treatment accorded to savings vehicles such as IRAs, is justified as good social policy that promotes savings." Barry J. Bidjarano, *Coping with the Reduced Limitation on "Compensation" Used Under Qualified Retirement Plans*, 68 ST. JOHNS L. REV. 357, 360 (1994) (stating that justification for tax incentives furthers policy of giving "fair and meaningful retirement savings" to employees).

To further promote employee savings, Congress more recently enacted the Savings Are Vital to Everyone's Retirement Act of 1997 (the "SAVER Act"), 111 Stat. 2139-45 (amending 29 U.S.C. § 1146(a)). The SAVER Act was passed because Congress found that the impending retirement of the baby boom generation would "severely strain our already overburdened entitlement system, necessitating increased reliance on pension and other personal savings," and that "far too many Americans — particularly the young

— are either unaware of, or without the knowledge and resources necessary to take advantage of, the extensive benefits offered by our retirement savings system." *See id.* § 2. The purpose of the SAVER Act is to promote public education and awareness of the need for personal retirement savings. H.R. Rep. No. 105-104, at 1 (1997), *reprinted in* 1997 U.S.C.C.A.N. 2768, 2770.

Deferred compensation plans like MasterShare promote Congress' policy goal of encouraging savings by subsidizing employee participation, which provides a strong financial incentive for employees to save. Furthermore, employees have the ability to defer taxes on the portion of their compensation received in the form of restricted stock. The employee tax advantage serves "to ensure that he or she will be taxed only when payments are actually received under the agreement; to permit deferred amounts to grow on a pretax and tax deferred basis during the deferral period; and to have amounts paid concurrently with some specific purpose such as retirement, purchase of a primary or secondary home, or sending a child to college." A. Thomas Brisendine, *et al.*, *Deferred Compensation Arrangements*, TAX MANAGEMENT (2002).

MasterShare — and programs like it — also provide employers with powerful incentives to invest in their employees. The costs of acquiring and developing human capital are high, and an employer generally incurs much of the expense before it can begin recouping its investment through the employee's work. A competitor that has not borne these costs can offer greater compensation to the employee, thus providing many employees with an incentive to leave their employers once they become marketable.[3] T.

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[3] This Court has recognized the challenges to employers of investing in employees only to see them leave for competitors. *Clark Paper & Mfg. Co.* v. *Stenacher*, 236 N.Y. 312, 319 (1923). In *Clark*, this Court cited the testimony of an employer who observed: "I

Lembrich, *Garden Leave: A Possible Solution to the Uncertain Enforceability of Restrictive Employment Covenants*, 102 COLUM. L. REV. 2291, 2296 (Dec. 2002). In such circumstances, "the original employer invests in the employee, but the competitor reaps the benefit." *Id.* Today, employees are forty percent more likely to change jobs voluntarily than they were five years ago. *Id.* at n.5. Accordingly, programs that provide incentives for employees to commit more time to a single firm also give employers more reason to invest in employee development.

Finally, promoting broker stability not only accords with SEC "best practices" and supports investment in employees, but also benefits the employer and the clients of the firm. Todd & Locke, at 1 (noting that restricted stock can be a powerful device to retain employees while aligning behavior with shareholder interests); *see also* S. Rep. No. 2375, 81st Cong., 2d Sess. 59, *reprinted in* 1950 U.S.C.C.A.N. at 3114 (discussing the uses of options envisioned by Congress, including attracting qualified corporate managers, retaining executives who might otherwise leave, and giving employees a more direct interest in the success of the business); Booknote, *Stakeholders as Shareholders*, 109 HARV. L. REV. 1150, 1151 (Mar. 1996) (explaining that restricted stock programs have the effect of "aligning the interests with the shareholders, protecting firm-specific interest, encouraging them to invest in more firm-specific human capital and provide greater flexibility to the firm than the traditional compensation alternatives of lifetime employment or high wages.").

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can recollect several men, at this time, who are now in the employ of competitors, salesmen, that we have spent our good time and our good money breaking in, men that we have taken and drilled and that we have gone through a period of no profit to the time when they commenced to make themselves worthwhile, simply to leave us and go with someone else." *Id.*

Brokers often move from one firm to another in order to receive bonuses or extra compensation that is paid when they sign up with a new firm. These practices unwittingly may promote "undue trading," whereby brokers take advantage of clients when they assume new employment and temporarily receive a higher payout on brokerage transactions. SEC, REPORT ON COMPENSATION PRACTICES at 11. By contrast, when brokers stay at the same firm for an extended period, clients are more sheltered from such practices. They also have more opportunities to learn about the products and services offered by the firms, along with the investment philosophies of the representatives assigned to their accounts. Furthermore, as explained above, the employees themselves stand to benefit from stronger education and training opportunities as a result of staying put. This, according to the SEC, further enhances the quality of advice that clients receive. *Id.* at 9.

Clients also benefit because MasterShare, and plans of its kind, condition receipt of the full value of the employees' shares on performance. Employees with substantial amounts of money subject to forfeiture will be highly motivated to keep all of their registrations updated, to avoid questionable trading, and to act to the best of their professional abilities. The possibility of losing an investment discourages behavior that could cause harm to clients and, when receipt of such compensation is contingent upon compliance with applicable securities regulations and continued tenure with the firm, ensures that employees will discharge their duties responsibly.

ARGUMENT

I.

INCENTIVE COMPENSATION DOES NOT CONSTITUTE "WAGES" WITHIN THE MEANING OF NEW YORK LABOR LAW AND MAY BE SUBJECT TO FORFEITURE CONSISTENT WITH THE GOVERNING COMPENSATION AGREEMENTS

A. The Text of the New York Labor Law Establishes That Incentive Compensation Does Not Qualify as Statutory "Wages"

The suggestion that Article 6 of the New York Labor Law was intended to prohibit contingent incentive compensation, including compensation plans of the type endorsed by the SEC, is refuted by the statute's express text. The Labor Law itself thus confirms that the term "wages" was never intended to encompass compensation such as the restricted shares at issue in the underlying litigation here.

Article 6 of the Labor Law codifies the provisions that govern payment of "wages." For purposes of Article 6, the Labor Law defines "wages" as "the earnings of an employee for labor or services rendered, regardless of whether the amount of earnings is determined on a time, piece, commission or other basis." N.Y. LABOR LAW § 190(1). To qualify as "wages," compensation therefore must have been "earn[ed]" and the associated labor or services must have been "rendered." *Id.*; *see also Engstrom* v. *Kinney Sys., Inc.*, 661 N.Y.S.2d 610, 614 (1st Dep't 1997) (holding that a prospective $1-per-hour reduction in salary did not implicate Article 6 of the Labor Law because no deductions had been made from wages already earned). These restrictions necessarily exclude unvested incentive compensation from the scope of statutory wages since such compensation is not "earned" unless, and until, all conditions precedent to payment — including continued employment — have been satisfied.

The provisions of New York's Labor Law that prescribe the manner in which statutory "wages" must be paid further establish that the term does not encompass incentive compensation. In particular, in the case of commissioned salespeople like Appellant Marsh, Section 191(1)(c) of the Labor Law provides that employers must pay wages "not less frequently than once in each month and not later than the last day of the month following the month in which they are earned." By its very nature, however, incentive compensation becomes due, if at all, when the specified performance criteria have been met. Such payments therefore necessarily must be linked to performance benchmarks rather than the mere passage of time. The impossibility of paying incentive compensation at regular intervals thus further confirms that such compensation does not qualify as "wages."

In point of fact, the Labor Law recognizes as much in Section 191(1)(c), which provides that, notwithstanding the general obligation that employers must pay commission salespeople their wages at least monthly, "if monthly or more frequent payment of *wages*, salary, drawing accounts or commissions are substantial, then additional compensation *earned*, including but not limited to *extra or incentive earnings, bonuses and special payments*, may be paid less frequently than once in each month, but in no event later than the time provided in the employment agreement or compensation plan." N.Y. LABOR LAW § 191(1)(c) (emphases added). The statute itself thus not only distinguishes between wages and incentive compensation, but also provides expressly that incentive compensation, even after it is earned, is not subject to the requirements applicable to statutory wages.

B. New York Federal and State Courts Uniformly Have Concluded That the Term "Wages" Does Not Encompass Incentive Compensation

The argument that the unvested compensation which participants in MasterShare and similar programs elected to receive should be deemed "wages" — and therefore be exempt from forfeiture under New York Labor Law § 193[4] — also has been foreclosed by an unbroken line of authority, culminating in this Court's definitive decision in *Truelove* v. *Northeast Capital & Advisory, Inc.*, 95 N.Y.2d 220 (2000).

To date, every reported federal and state court decision interpreting New York law has held that "stock award plans like this one, whose objectives are to retain talented executives by providing them with a proprietary interest in the growth and performance of the company, are not 'wages' under § 190 of the New York Labor Law." *Int'l Bus. Mach. Corp.* v. *Martson*, 37 F. Supp. 2d 613, 617 (S.D.N.Y. 1999); *see also Rosenberg* v. *Salomon Inc.*, 992 F. Supp. 513, 518 (D. Conn. 1997) (incentive compensation not "wages" within the meaning of the New York Labor Law); *Int'l Paper Co.* v. *Suwyn*, 978 F. Supp. 506, 514 (S.D.N.Y. 1997) (same); *Canet* v. *Gooch Ware Travelstead*, 917 F. Supp. 969, 995 (E.D.N.Y. 1996) (same); *Tischmann* v. *ITT/Sheraton Corp.*, 882 F. Supp. 1358, 1370 (S.D.N.Y. 1995) ("Under New York law, incentive compensation based on factors falling outside the scope of the employee's actual work is precluded from statutory coverage."), *aff'd*, 145 F.3d 561 (2d Cir.), *cert. denied*, 525 U.S. 963 (1998); *Samuels* v. *Thomas Crimmins Contracting Co.*, No. 91 Civ. 6657, 1993 WL 36168 at *7 (S.D.N.Y. Feb. 9, 1993) (same).

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[4] Labor Law § 193 provides that "[n]o employer shall make any deduction from the wages of an employee."

Indeed, a claim similar to that raised here by Appellant Marsh was advanced by Stephen Martson in *Int'l Business Machines Corp.* v. *Martson*, 37 F. Supp. 2d 613 (S.D.N.Y. 1999) — and was decisively rejected by the United States District Court for the Southern District of New York, following settled precedent. In that case, IBM maintained a Long-Term Performance Plan that had been designed to attract and retain key executives and other selected employees whose skills and talents were considered important to the company's operations. The Plan enabled designated employees to receive stock option awards that became exercisable pursuant to a schedule set forth in the stock option agreements. Those stock option agreements further provided that the stock option awards were subject to forfeiture if the recipient went to work for a competitor within a specified time period.

After receiving a stock option award, plaintiff Martson exercised his options and promptly resigned from IBM to work for Compaq, a direct competitor. After Mr. Martson refused to repay the profits he had realized from the exercise of the options, as required by the unambiguous terms of the stock option agreements, IBM sued him for breach of contract. Mr. Martson argued in response that the stock options he received pursuant to the Long Term Performance Plan constituted "wages" under New York's Labor Law § 190(1) and that the forfeiture provision therefore was unenforceable. *Id.* at 617.

The district court rejected Mr. Martson's argument. As an initial matter, the court reaffirmed the settled principle that unvested incentive compensation does not constitute "wages" within the meaning of § 190 of the New York Labor Law. *Id.* at 617; *see also Dean Witter Reynolds Inc.* v. *Ross,* 429 N.Y.S.2d 653, 658 (1st Dep't 1980)

(incentive pay does not constitute "wages" until it is actually earned and vested). In *Martson*, however, unlike the situation here, Mr. Martson's shares had already vested (albeit subject to the risk of forfeiture). The court therefore examined several additional factors to determine whether the shares should be considered "wages," including the terms of the bonus or award plan, whether the employee had fixed compensation in addition to the possibility of an award under the plan, and whether the additional compensation was contingent on factors outside the employee's actual work. *Id.* at 618.

After considering these factors, the district court ruled that Mr. Martson's stock option awards were not "wages" under New York Labor Law. First, the terms of IBM's governing compensation plan established that the stock awards were intended to give participants a long-term interest in the company. *Id.* Second, Mr. Martson received fixed compensation in addition to the possibility of the stock award, further negating any inference that the incentive payment should be deemed "wages." *Id.* (citing *Samuels* v. *Thomas Crimmins Contracting Co.*, No. 91 Civ. 6657, 1993 WL 36168 at *7 (S.D.N.Y. Feb. 9, 1993)). Third, payment of the award was not directly related to Mr. Martson's work, but was, at least in part, contingent on other factors. *Id.*

Martson further corroborates that enforcement of the forfeiture provisions in MasterShare and similar compensation plans used in the securities industry is fully consonant with New York Labor Law. In accordance with well-settled law, the restricted stock awarded pursuant to MasterShare and similar programs cannot be considered "wages" because, under the express terms of the governing agreements, the shares constitute unvested incentive compensation. Moreover, even if the shares had been vested, analysis of each of the *Martson* factors compels the conclusion that the restricted stock

awards are incentive compensation, not statutory "wages." First, as in *Martson*, MasterShare and similar programs, by their express terms, were designed to attract and retain employees and to provide them with a long-term interest in the success of the firm. *Id.* at 617; *see also Rosenberg*, 992 F. Supp. at 518 (noting that stock awards were intended to give the participant a long-term interest in the firm). Second, such programs expressly provide for the receipt of fixed compensation in addition to the possibility of an award of restricted stock. *See Samuels*, 1993 WL 36168 at *7 (holding that a fixed method of compensation may include salary, bonus or commission). Third, the restricted stock awards and the value of those awards are contingent on factors falling outside the actual work of the employee — namely, continued employment with the firm throughout the vesting period and, in some cases, the overall success of the employer or the stock market. *See Rosenberg* v. *Salomon Inc.*, 992 F. Supp. 513, 518 (D. Conn. 1997) (holding that payment of a stock award was not contingent on plaintiff's actual work when entitlement to the award depended on expiration of a five-year investment period); *Dean Witter*, 429 N.Y.S.2d at 658 (incentive plan tying an employee's bonus to overall output rate of the department fell outside the purview of Labor Law § 190).

Drawing upon the reasoning of *Martson* and similar precedents, this Court also recently dismissed a statutory wage claim identical in all material respects to that asserted by Appellant Marsh. In *Truelove* v. *Northeast Capital & Advisory Inc.*, 95 N.Y.2d 220 (2000), this Court expressly rejected plaintiff's contention that the unvested portion of a contingent bonus, which plaintiff Truelove had forfeited when he voluntarily resigned from his firm, constituted earned wages under New York Labor Law. Accordingly, this Court ruled that the defendant employer had not violated the Labor Law

when it enforced an express provision of its bonus plan that predicated payment of a declared bonus on plaintiff's continued employment at specified dates in the future.

Plaintiff William B. Truelove, a financial analyst at an investment banking firm, elected to participate in a compensation plan under which he was to receive an annual salary and would be eligible to participate in an incentive compensation plan. Thereafter, in December 1997, Mr. Truelove was awarded a bonus, in addition to his regular salary. Pursuant to his employer's incentive plan, Mr. Truelove's bonus was payable in quarterly installments throughout 1998, each payment contingent upon his continued employment with the firm. The memorandum announcing the firm's bonus plan expressly stated that the requirement of continued employment was included "as a result of prior actions taken by previous employees who received the bonus and then immediately left the firm." *Truelove* v. *Northeast Capital & Advisory Inc.*, 702 N.Y.S.2d 147, 148 (3rd Dep't 2000).

After the firm's CEO allocated $160,000 of the profit sharing pool to Mr. Truelove and the firm paid him the first installment of his bonus, Mr. Truelove resigned from the firm, whereupon his former employer declined to make further payments. In his subsequent lawsuit, Mr. Truelove alleged that his bonus award constituted "earned wages" under the New York Labor Law, and that defendant's failure to pay the remaining three installments of his bonus violated Labor Law § 193, which prohibits deductions from earned wages.

This Court rejected Mr. Truelove's claims. In a unanimous decision, this Court ruled that certain forms of "incentive compensation" that are more in the nature of a profit-sharing arrangement are not "wages" within the meaning of § 190 *et seq.* of the New York Labor Law. *Truelove*, 95 N.Y.2d at 223-24. The Court expressly held, as had every

other court to consider the question, that the definition of "wages" excluded incentive compensation "based on factors falling outside the scope of the employee's actual work." *Id.* at 224. The Court also squarely rejected Mr. Truelove's argument that his right to bonus payments vested when his employer determined that he would receive a specific bonus, reaffirming that an "employee's entitlement to a bonus is governed by the terms of the employer's bonus plan." *Id.* at 225 (*quoting Hall* v. *United Parcel Service*, 76 N.Y.2d 27, 36 (1990)). As a result, the Court determined that Mr. Truelove was not entitled to any bonus payments after his resignation since he had failed to satisfy the bonus plan's express requirement that he remain in the employ of the company.

This Court's decision in *Truelove*, consistent with an unbroken line of federal and state authority interpreting New York law, confirms that the restricted stock received by participants in MasterShare and similar incentive compensation programs does not constitute wages within the meaning of § 190 of the New York Labor Law.

The express terms of MasterShare and similar plans prevalent in the securities industry foreclose any claim that New York Labor Law entitles employees to unvested restricted stock awards. Under *Truelove*, and a long line of federal and state court precedent, an employee's right, if any, to receive contingent incentive compensation is governed by the terms of the employer's plan. In the securities industry, such plans generally provide that restricted stock awarded to brokers does not vest for two to three years and that the employee's voluntary resignation from the firm prior to vesting results in forfeiture of the restricted stock. Thus, just as in *Truelove*, such payments are both "contingent" and "based on factors falling outside the scope of the employee's actual work," since the restricted stock vests only if plan participants remain at their employers

for a specified time period and the value of the stock at that point reflects not only the employee's actual work, but also the overall performance of the market, in the case of MasterShare, or the employer, in the case of several similar plans. MasterShare and similar plans, implemented to encourage employee performance and retention, thus are materially indistinguishable from the contingent incentive compensation plan approved by this Court in *Truelove*.

C. The Absence of Any Legislative Response Suggests that the New York Legislature Has Endorsed the Widespread Use of Incentive Compensation and Concurs With Court Decisions Holding That Article 6 of the Labor Law Has No Application to Such Compensation

As discussed above, the use of incentive compensation plans has increased dramatically in recent years. Contingent compensation programs, precisely like the MasterShare program at issue here, have been adopted by companies throughout New York and elsewhere to promote employee retention and strengthen employee commitment. Moreover, the use of such incentive compensation programs has received extensive media coverage. *See, e.g.*, Andrew Bary, *Stock Answer: Restricted Shares May Supplant Options as Incentive Payment*, BARRON'S, Jan. 27, 2003 (noting that "restricted stock is company stock granted to employees that typically vests over an extended period, such as three years," and that, on Wall Street, "restricted stock generally has been part of employee bonuses in the past decade"); Carolyn T. Geer, *Making the Most of Restricted Stock*, FORTUNE, May 1, 2000 (reporting that restricted stock vests over time); Robert Lenzner, *Whose Rolodex Is It, Anyway?*, FORBES, Feb. 23, 1998 (observing that "[i]ncreasingly Wall Street firms are deferring a portion of annual bonuses in restricted stock over several years so that an employee loses a portion of bonuses if he leaves"); *Retooling Stock-Option*

Plans for the Bear Market, INC., Jan. 1, 1988 (describing restricted stock plans that use forfeiture provisions to promote employee retention). Moreover, the SEC expressly has advocated the use of contingent compensation plans as a "best compensation practice" in the securities industry to align the incentives of brokers, clients and employers.

And notwithstanding the fact that such contingent compensation plans typically, if not invariably, contain a forfeiture provision that provides the economic incentive for employees to achieve specified performance or employment objectives, the New York Legislature has taken no action to prohibit this practice. Nor has it ever suggested that it considered such contingent compensation to contravene Section 193 of the Labor Law, which prohibits deductions from "wages."

If the Legislature had deemed the increasingly common use of contingent incentive compensation plans to be contrary to the New York Labor Law, it presumably would have amended Article 6 to proscribe the practice. In fact, the New York Legislature has amended various provision of Article 6 at least *sixteen times* since 1980, but has never intimated, let alone expressly stated, that the provisions governing payment of statutory "wages" had any application to contingent incentive compensation.[5] Such legislative inaction demonstrates convincingly that such plans do not violate the Labor Law's

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[5] *See* Art. 6, N.Y. Labor Law §§ 190-198, *as amended by* L. 1980 § 1 (amending section 194), L. 1981, ch. 256 § 1 (amending section 195), L. 1981, ch. 475 § 1 (amending section 192), L. 1984, ch. 496 § 1 (amending section 190), L. 1985, ch. 336 § 1 (amending section 196), L. 1987, ch. 404 § 1 (amending section 191), L. 1989, ch. 38 §1 (amending section 191), L. 1989, ch. 61 § 223 (amending section 192), L. 1989, ch. 177 § 1 (amending section 198), L. 1990, ch. 163 § 1 (amending section 198), L. 1992, ch. 165 § 1 (amending section 190) and § 2 (amending section 192), L. 1992, ch. 165 § 3 (amending section 198), L. 1993, ch. 168 § 1 (amending section 191), L. 1994, ch. 170 § 205 (amending section 192), L. 1997, ch. 605 § 3 (amending section 196) and §§ 4-5 (amending section 198), and L. 2002, ch. 281 § 1 (amending section 190).

prohibition on the forfeiture of earned "wages." *See* N.Y. STAT. LAW § 127 & cmt. ("[T]hose usages which have grown up in connection with a statute after its enactment may afford a practical consideration of it which will be respected by the courts."); *RKO-Keith-Orpheum Theatres* v. *City of New York*, 308 N.Y. 493, 499 (1955) ("If the practical construction of a statute is well known, the Legislature is charged with knowledge and its failure to interfere indicates acquiescence therein.").

Federal and state courts in New York also consistently have taken the view that New York Labor Law prohibiting the forfeiture of statutory wages has no application to contingent incentive compensation. In an unbroken line of authority extending back decades, courts uniformly have ruled that contingent incentive compensation falls outside the statutory definition of "wages" and therefore may be subject to forfeiture in accordance with the terms of the governing compensation agreements.[6] The New York Legislature is

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[6] *See, e.g.*, *Ellis* v. *Provident Life & Accident Ins. Co.*, 3 F. Supp. 2d 399, 413 (S.D.N.Y. 1998) (incentive bonus paid to branch manager based on branch revenue not "wages" under New York Labor Law), *aff'd*, 172 F.3d 37 (2d Cir. 1999); *Int'l Paper Co.* v. *Suwyn*, 978 F. Supp. 506, 514 (S.D.N.Y. 1997) (incentive compensation based on factors falling outside the scope of the employee's actual work, such as the overall performance of the employer, falls outside the protection of New York Labor Law § 190); *Colangelo* v. *Fresh Perspectives, Inc.*, 948 F. Supp. 331, 332 (S.D.N.Y. 1996) (incentive compensation does not qualify as "wages" under New York Labor Law); *Canet* v. *Gooch Ware Travelstead*, 917 F. Supp. 969, 995-96 (E.D.N.Y. 1996) (bonus, even when guaranteed as part of employment contract, constitutes incentive compensation and therefore was not "wages" under New York Labor Law); *Tischmann* v. *ITT/Sheraton Corp.*, 882 F. Supp. 1358, 1370 (S.D.N.Y. 1995) (bonus not "wages" within the meaning of New York Labor Law where incentive plan gave employer complete discretion whether to declare a bonus); *Samuels* v. *Thomas Crimmins Contracting Co.*, No. 91 Civ. 6657, 1993 WL 36168, at *6 (S.D.N.Y. Feb. 9, 1993) (bonus dependent on factors other than employee's performance not "wages" under New York Labor Law); *Magness* v. *Human Resources Serv., Inc.*, 555 N.Y.S.2d 347, 349 (1st Dep't 1990) (holding that incentive compensation based on the employer's revenue was not "wages" under Labor Law § 190(1)); *Dean Witter Reynolds, Inc.* v. *Ross*, 429 N.Y.S.2d 653, 658 (1st Dep't 1980) (ruling that the term "wages" does not encompass an incentive compensation plan); *Markby* v. *PaineWebber Inc.*, 650 N.Y.S.2d 950, 954 (Sup. Ct. N.Y. Co. 1996) (confirming NYSE arbitration award that rejected investment banker's claim to unvested

presumed to be aware of these decisions. *See, e.g., Matter of Cole's Estate*, 235 N.Y. 48, 52 (1923) (holding that the Legislature is assumed to have knowledge of judicial decisions interpreting the existing law). As the Legislature has left undisturbed for nearly twenty-five years the unanimous judicial view that New York's wage laws have no application to incentive compensation, it must be understood to have endorsed that statutory interpretation.

II.

PROSPECTIVE AGREEMENTS CONCERNING COMPENSATION CANNOT EFFECT A DEDUCTION FROM "WAGES" AND THEREFORE ARE NOT SUBJECT TO LABOR LAW SECTION 193

No doubt recognizing that precedent and the statutory language foreclose any argument that his MasterShare restricted and unvested stock constitutes statutory wages, Appellant Marsh instead urges this Court to conclude that his voluntary election to receive part of his future compensation in the form of restricted stock results in an unlawful deduction from wages. Appellant Marsh thus argues that because he had the option of receiving all of his compensation in the form of commissions, his prospective decision to receive part of his future compensation in the form of restricted stock constitutes a deduction from "wages" within the meaning of Labor Law § 193. This argument fails as a matter of law and logic.

As discussed above, the term "wages" refers to amounts that already have been earned. The statutory language makes this clear since it defines "wages" as the

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restricted stock granted as part of an incentive compensation program because, whereas earned wages are not subject to forfeiture under the New York Labor Law, restricted stock was a discretionary bonus and thus subject to forfeiture under the express terms of the employer's bonus plan).

"earnings of an employee for labor or services *rendered*." N.Y. LABOR LAW § 190(1) (emphasis added). The use of the past tense signifies unmistakably that application of the Labor Law concerning payment of "wages" is limited to amounts that the employer has an existing obligation to pay. *See Engstrom* v. *Kinney Sys., Inc.*, 661 N.Y.S.2d 610, 614 (1st Dep't 1997) (holding that a prospective $1-per-hour deduction from salary did not implicate Section 193 of the Labor Law because no deductions had been made from wages already earned).

Common sense mandates such a result because to hold otherwise would mean that New York Labor Law prohibits employers from adjusting wage rates.[7] This position has no legal support. To the contrary, courts repeatedly have recognized that employers *are* entitled to set the terms of their employees' compensation. *See, e.g.*, *Hanlon* v. *Macfadden Publ'ns*, 302 N.Y. 502, 547 (1951) (holding that employer "at all times had the right to fix his [employee's] compensation, to reduce it or to change it, without assigning any reason therefore."). It is well-settled that neither Section 193 nor any other section of Article 6 abrogates the right of employers to establish wage rates for their employees. *See Dwyer* v. *Burlington Broad. Inc.*, 744 N.Y.S.2d 55, 57 (3d Dep't 2002) (recognizing that employer was free to modify the terms of employment for an at-will employee, including by prospectively eliminating her right to post-termination commissions, subject only to her right to leave her employment if she found the new terms unacceptable); *Gebhardt* v. *Time Warner Entm't-Advance/Newhouse*, 726 N.Y.S.2d 534,

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[7] As this Court has noted, in the absence of a clear legislative mandate, statutes should not be read to produce such absurd results. *See Hudacs* v. *Frito-Lay, Inc.*, 90 N.Y.2d 342, 348 (1997).

535 (4th Dep't 2001) (holding that employer could not change commission rate of an at-will commissioned sales representative for deal that already had been booked, but could reduce commission rate prospectively, subject to her right to resign if she found the new terms unacceptable).

The law therefore is clear that Respondent Prudential unquestionably had the right prospectively, and even unilaterally, to reduce Appellant Marsh's commission rate. As a consequence, Prudential necessarily was within its rights to reduce Marsh's commission rate while offering him the opportunity to receive additional compensation contingent on continued employment. And inasmuch as Prudential could have mandated such a revised compensation structure for all its retail brokers, it defies logic to suggest that the firm somehow lacked authority to offer its employees the option of receiving their compensation entirely in the form of commissions or as a combination of commission, albeit at a reduced rate, and contingent incentive compensation, such as restricted stock.

Indeed, this Court's decision in *Truelove* rules out Appellant Marsh's argument that Section 193 requires an employer to refund the commissions or salary that could have been earned absent the employee's own election to receive contingent compensation. Much like Appellant Marsh, the plaintiff in *Truelove* elected to participate in a bonus pool involving a risk of forfeiture rather than receive higher fixed compensation. 95 N.Y.2d at 222. As noted previously, this Court rejected Mr. Truelove's argument that his unvested bonus constituted "wages" within the meaning of New York Labor Law. It also never suggested that Section 193 required Mr. Truelove's employer to refund the additional fixed compensation that he agreed to forgo when he elected to participate in the bonus pool. As in *Truelove*, Appellant Marsh and tens of thousands of

other financial professionals in brokerage firms across New York have elected to receive a portion of their income in the form of restricted stock rather than fixed commissions. This Court's decision in *Truelove* confirms that New York Labor Law does not entitle Marsh and similarly situated employees to whatever additional fixed compensation they might have received had they elected otherwise.

III.

IN ALL EVENTS, EVEN DEDUCTIONS FROM WAGES FOR RESTRICTED STOCK PROGRAMS LIKE MASTERSHARE WOULD BE PERMISSIBLE UNDER SECTION 193 OF THE LABOR LAW BECAUSE SUCH DEDUCTIONS ARE FOR THE BENEFIT OF THE EMPLOYEE

Even if, contrary to law and fact, MasterShare and similar compensation programs involved deductions from "wages" within the meaning of Section 193, such deductions still would be permissible pursuant to the express terms of Article 6. In particular, Section 193 allows employers to make deductions from wages that are authorized in writing by the employee and "for the benefit of the employee." N.Y. LABOR LAW § 193(1)(b). As reflected in the question that the United States Court of Appeals for the Third Circuit certified to this Court, it is undisputed that MasterShare, like similar programs adopted in the securities industry, involves deductions made with "an employee's written and informed authorization." *See Marsh* v. *Prudential Securities Inc.*, No. 02-2528, Pet. for Certification of Questions of Law 16 (3d Cir. Mar. 3, 2003). The only question here is whether these deductions are "for the benefit of the employee." Even a cursory examination of MasterShare and similar programs confirms that deductions authorized thereunder benefit participating employees in several ways.

MasterShare and similar programs provide employees who elect to participate with a potentially lucrative investment opportunity. In the case of MasterShare, in particular, retail brokers receive the opportunity to receive between 5 and 25 percent of their pretax compensation in the form of restricted shares in a Prudential index fund that tracks the S&P 500. Prudential also makes these shares available to participating brokers at a 25 percent discount to the market price.

The MasterShare program, similar to other programs offered in the securities industry, thus affords employees two substantial benefits. First, the 25 percent discount on restricted shares awarded in the program operates as a 33⅓ percent employer-financed subsidy on each dollar that participants elect to receive in the form of restricted MasterShare stock. *See id.* at 4. The employer, in this case Prudential, funds this subsidy exclusively for the benefit of participating employees.

Second, MasterShare participants receive the benefit of a deferral of federal income tax on all amounts — including Prudential's subsidy — that are invested on their behalf through the MasterShare Plan. The Third Circuit noted that Prudential designed MasterShare for the express purpose of taking advantage of Internal Revenue Code § 83, which permits taxation to be deferred on property subject to a substantial risk of forfeiture. *See id.* at 3. Restricted shares awarded pursuant to MasterShare thus are subject to forfeiture if the employee leaves the firm or is terminated for cause. Absent this risk of forfeiture, the tax deferral benefits of Section 83 would be unavailable to Prudential employees. *See id.* at 3 ("To allow its employees to defer taxation by making this 'Section 83 election,' PSI designed its MasterShare Plan to impose upon participating employees

CONCLUSION

For the reasons stated above, the Securities Industry Association respectfully requests that this Court rule that Appellant Marsh's election to receive part of his future compensation in the form of contingent incentive compensation, and Prudential's implementation of that election, does not constitute an unlawful deduction from "wages" within the meaning of Section 193 of the New York Labor Law and, in all events, that authorized deductions pursuant to MasterShare and similar incentive compensation plans are permissible under Section 193.

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New York, New York

Respectfully submitted,

Brad S. Karp
Daniel J. Toal
Daniel R. Garodnick

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP
1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

Attorneys for *Amicus Curiae* Securities Industry Association