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Employment

Schulte Roth & Zabel Partners Discuss Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements

By Richard Chen

Restrictive covenants, including non-competition clauses, are commonly misunderstood, and such misunderstandings can cause problems not only for employees, but also employers. When hedge fund managers hire new employees, these types of restrictions are often included in employment agreements or in partnership agreements (or side letters), often when an employee or partner is granted an interest in the fund manager's profits. Additionally, they can be found in purchase agreements when a fund manager sells some or all of its business. See "Buying a Majority Interest in a Hedge Fund Manager: An Acquirer's Primer on Key Structuring and Negotiating Issues," The Hedge Fund Law Report, Vol. 4, No. 17 (May 20, 2011). When properly drafted and applied, restrictive covenants can protect an employer against harm created by the theft or misuse of valuable proprietary firm information. When improperly drafted or applied, such restrictive covenants may not be enforced and will not provide the desired protection. In addition, fund managers hiring new employees who may be subject to restrictive covenants should take certain precautions to avoid allegations that they aided or abetted a breach of a restrictive covenant which can cause reputational harm, among other things.

On November 10, 2011, Ronald E. Richman and Holly H. Weiss (SRZ Partners), both partners at Schulte Roth & Zabel LLP, hosted a seminar entitled "Restrictive Covenant Issues for Investment Managers" (Seminar) in which they discussed a variety of issues relevant to hedge fund managers, including the different types of restrictive covenants, common misconceptions about restrictive covenants, how to properly draft restrictive covenants, how restrictive covenants are analyzed by the courts, what happens once a dispute involving restrictive covenants arises and best practices for hedge fund manager employers looking to hire prospective employees. For the most part, Richman and Weiss focused on restrictive covenants in the employment arena. This article summarizes the issues discussed by the SRZ Partners and includes additional guidance relevant for hedge fund managers dealing with restrictive covenants.

What Are the Different Types of Restrictive Covenants?

In the hedge fund arena, the most commonly used restrictive covenants include provisions relating to non-competition by employees, non-solicitation of investors, non-solicitation of employees and confidentiality. State law governs restrictive covenants. With few exceptions, such as Section 16600 of the California Business and Professions Code (which prohibits non-competition clauses in the employment context in California), few states have statutes governing restrictive covenants. The law in most states has been shaped over time by common law jurisprudence. As a result, the law governing restrictive covenants can vary widely from state to state, and it is imperative that hedge fund managers understand applicable state laws. In addition, the outcome of a particular dispute is very sensitive to the underlying facts. When determining whether to enjoin conduct prohibited by a restrictive covenant, courts consider equitable principles, weighing the harm to the employee against the benefit to the employer. Fund managers should be attentive to the fact that such equitable considerations play a role in determining the outcome when disputes arise.

Non-Competition Covenant

The most widely discussed and perhaps most commonly misunderstood of the restrictive covenants is the non-competition covenant. This covenant essentially restricts a departing employee from competing against his employer in an identical or similar line of business once employment is terminated and for a specified period thereafter.

The SRZ Partners pointed to a popular misconception that restrictive covenants are generally unenforceable. They noted that while this may have been true 15 to 20 years ago, it is no longer accurate. The SRZ Partners noted that today courts are willing to enforce non-competition clauses as long as they protect an employer's legitimate interests in trade secrets or confidential information or protect its unique relationships with investors that it has spent a great deal of time and money cultivating. The SRZ Partners pointed out that information to be protected must be secret and valuable to competitors. For instance, an investment strategy of buying low and selling high generally would not be protected because it is neither secret nor valuable to competitors. In addition, to protect information as confidential, the firm should be able to point to safeguards it uses to protect such information. For instance, information that is disseminated to industry analysts cannot be protected. In addition, to be considered confidential, the employer should adopt safeguards to prevent its vendors or investors with whom the employer shares information from sharing information with other parties.

On a related note, the SRZ Partners also pointed to a misconception that restrictive covenants are allowed to be used to "tie" a person to the firm. The SRZ Partners noted that this is not true, although they acknowledged that some firms may use restrictive covenants to discourage employees from leaving. The SRZ Partners cautioned, however, that non-competition covenants that are designed to restrict an employee's employment options post-employment, rather than to protect the employer's legally protected interests, may not be enforced.

The SRZ Partners noted that to maximize the likelihood that a non-competition clause will be enforced, the drafter should ensure that it is reasonable in scope, duration and geography. The SRZ Partners noted that it would be more difficult to enforce a non-competition clause that prohibits the employee from becoming employed in the investment management industry as a whole as opposed to a narrower covenant that merely prohibits the employee from becoming employed by a fund employing a similar investment strategy or in a particular sector. The SRZ Partners noted that in determining the appropriate scope of the restriction, the drafters should think specifically and not generally when considering what type of information is being protected and draft the non-competition covenant accordingly to cover such information. The SRZ Partners noted that it may be difficult to enforce a covenant designed to protect a fund's investment process unless the fund can point out the aspects of the investment process that constitute trade secrets or confidential information.

In discussing what temporal restriction is reasonable in the hedge fund industry, the SRZ Partners noted that the general rule of thumb is that a restriction of six months to one year would likely be considered reasonable in the hedge fund industry. When considering the temporal scope of a restrictive covenant, courts usually consider the period before the protected information becomes stale.

The SRZ Partners commented that the reasonableness of the geographic scope of a covenant has become less significant in the hedge fund industry, because hedge fund management businesses are usually global. As a result, the SRZ Partners noted that funds may consider limiting the reach of restrictive covenant to those locations in which the fund's investors are located.

As noted above, courts also look to equitable considerations when determining whether to enjoin breaches or threatened breaches of a non-competition provision. Generally, courts will weigh the harm to the employee against the benefit to the employer. One factor courts often consider is whether the subject employee would be paid to "sit out" during the period that the covenant is in effect. If the employee would be compensated, the courts may be more likely to enforce the covenant because the harm to the employee has been mitigated. The SRZ Partners noted, however, that during the past 12 to 18 months, this equitable factor has waned in significance. Some courts have reasoned that there is still significant harm to an employee if he or she is required to sit out for an extended period, even if he or she is compensated, given the difficult conditions in today's economic climate.

Courts also look at the circumstances surrounding an employee's departure. Reasonably drafted non-competition covenants are more likely to be enforced against employees who voluntarily resign or whose employment has been terminated for cause (because an employee has control over the circumstances that result in a cause termination). However, the answer is less clear when it comes to an employee whose employment is terminated without cause. Courts seem to be more reluctant to enforce non-competition clauses in such circumstances.

Also, courts may consider whether the non-competition clause is heavily negotiated. Courts may be more willing to enforce restrictive covenants that are heavily negotiated between the employer and the employee, as opposed to covenants that are unilaterally proposed by the employer and not tailored or negotiated.

Courts will also often look at whether any of the parties has unclean hands. If a departing employee's new employer has a history of raiding other companies for employees, the court may be more likely to enforce the restrictive covenant. If there is evidence that the departing employee has misappropriated trade secret information, a court is more likely to enforce the restrictive covenant.

Courts that determine that a non-competition clause or another restrictive covenant is too broad to be enforced as written may refuse to enforce the covenant at all. Alternatively, in some jurisdictions, including New York, the court may, but is not required to, "blue pencil" or modify the clause to make it reasonable and enforce the modified covenant. That a court may modify a restrictive covenant is not a reason to draft a covenant that is unreasonably broad in scope or duration.

Non-Solicitation of Investors

Non-solicitation of investor covenants prohibit a departing employee from undermining relationships that his or her former employer has expended time and resources to develop

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with its investors for a period after termination of employment. Provided that they are reasonable, these restrictions (and other non-solicitation and confidentiality restrictions) are more likely to be enforced than non-competition restrictions because they do not limit an employee's employment options after termination of employment.

To be enforced, these types of covenants must be reasonable in scope and duration. The SRZ Partners noted that market practice is for these restrictions to remain in effect for one year following termination of employment. Restrictions lasting shorter or longer are also used.

A key question when dealing with non-solicitation of investor covenants is determining when a "solicitation" has taken place. The SRZ Partners pointed to a scenario whereby an investor of the former employer approaches an employee at his new firm and broaches the idea of investing money with the new employer. This is unlikely to constitute solicitation because the employee did not initiate the communication with the investor. The situation becomes less clear if, in response to the investor's inquiry, the employee provides marketing materials to the investor. While this may constitute sales activity, the SRZ Partners noted that courts may not consider this to be "solicitation," because the investor reached out to the employee first. Depending on the particular facts, however, a court may determine that a breach has occurred. It is sometimes difficult for an employer to prove that solicitation occurred as an evidentiary matter. Employers, therefore, may impose a provision that not only prohibits a former employee from soliciting the business of an investor, but also prohibits the former employee from doing business with the investor. Employers should consider the practical implications of such an approach on the employer's ongoing relationship with its investors.

Non-Solicitation of Employees

These types of covenants prevent a former employee from encouraging a former employer's personnel to leave, and they are very common in the hedge fund arena. They are also limited in duration, with a common restriction remaining in effect for one year to eighteen months following termination of employment. These types of covenants also involve similar issues as those that arise when dealing with non-solicitation of investor covenants. To avoid evidentiary issues as to whether a former employee has solicited employees, these covenants are often structured to prevent a former employee or his or her new firm from hiring any employee from the former employer during the restricted period.

The SRZ Partners noted that a common misconception among employees is that if they are not bound to any restrictive covenants, they can permissibly solicit employees and investors away while they are still employed or that their restrictive covenants do not kick in until they leave. In fact, restrictive covenants are generally structured to prohibit such behavior even before employment is terminated, and it is not permitted even in the absence of a restrictive covenant. Fund managers should be particularly wary when groups of employees terminate employment almost simultaneously to go to a single new employer because this is likely to indicate that a certain amount of collusion took place while the employees were still employed by the former employer.

Confidentiality Covenants

Confidentiality provisions are very commonly applied to hedge fund employees, and they are designed to protect the employer's trade secrets and confidential and proprietary information. These provisions generally do not have any limitations on duration. The SRZ Partners cautioned against defining the confidential information to be protected in an unreasonably broad manner. For instance, a drafter should not include information that is generally available to the public among the confidential information to be protected. This is because the drafter may lose credibility when the issue of whether information is actually confidential is brought before a judge. See also "Protecting Hedge Funds' Trade Secrets: The Federal Government's Enforcement of Criminal Laws Protecting Proprietary Trading Strategies," The Hedge Fund Law Report, Vol. 3, No. 48 (Dec. 10, 2010).

Bad Boy Clauses

These are provisions that permit competition, but disincentivize it by taking away compensation or benefits, such as unpaid deferred compensation or sunset payments, from employees who leave and join competitors. In some cases, the mere allegation of competition is sufficient to trigger forfeiture of the benefit. See "Key Legal Considerations in Connection with the Movement of Talent from Proprietary Trading Desks to Start-Up or Existing Hedge Fund Managers: The Bank Perspective (Part Two of Three)," The Hedge Fund Law Report, Vol. 4, No. 2 (Jan. 14, 2011). In New York, these provisions need not be reasonable in scope or duration to be enforced provided they are applied when employees resign, and not when they are terminated without cause. These provisions do not generally present the same type of enforceability problems as non-competition provisions because they do not prevent an employee from obtaining other employment. The SRZ Partners noted that these provisions have become increasingly prevalent in the hedge fund arena.

Handling Disputes Involving Restrictive Covenants

Despite careful drafting, employers may not be able to avoid disputes involving restrictive covenants. As a result, the SRZ Partners provided a roadmap as to how a hedge fund manager employer should prepare for disputes and handle disputes once they arise.

The SRZ Partners noted that employers should consider requiring notice provisions in employment agreements to afford employers time to respond to any disputes that may occur prior to the departure of an employee. Employers often ask departing employees about their next steps to determine whether any action must be taken to enforce a restrictive covenant. If the employer determines that the employee is about to or has already violated the non-competition clause, the employer can seek a temporary restraining order to stop the employee from working for the new employer.

To maximize the likelihood of having a request for a temporary restraining order granted, an employer should file its motion, if possible, prior to the employee's commencement of employment with a new employer. It is generally more difficult to obtain a temporary restraining order once the employee has started work with his or her new employer. A temporary restraining order will preserve the status quo for a brief period (usually one to two weeks) pending a hearing on the employer's motion for a preliminary injunction. During the period the temporary restraining order is in place, both sides prepare for a preliminary injunction hearing where they make their legal arguments and call witnesses to testify. Once the court rules on the preliminary injunction, the losing side may appeal the decision, and the employer may continue to pursue a damages claim. In many cases, the dispute ends at the preliminary injunction stage.

Precautions To Be Taken When Hiring New Employees

Fund managers that are interviewing prospective new hires should conduct thorough due diligence. In the first instance, a fund manager should inquire whether a prospective employee is subject to any restrictive covenants. If the employee is subject to a restrictive covenant and the employee is hired, the employer should carefully monitor the employee's behavior to ensure that the employee is not breaching any of his restrictive covenants. See "Key Legal Considerations in Connection with the Movement of Talent from Proprietary Trading Desks to Start-Up or Existing Hedge Fund Managers: The Hedge Fund Manager Perspective (Part Three of Three)," The Hedge Fund Law Report, Vol. 4, No. 4 (Feb. 3, 2011).

When interviewing prospective employees, employers should take note of any conduct that could indicate a potential problem. For instance, if the prospective employee offers to disclose confidential information from his or her former employer to the new employer, offers to share what appears to be material nonpublic information or indicates that he or she has had discussions with his or her colleagues encouraging them to join him or her prior to his or her departure, the fund manager should consider whether it is appropriate to hire the prospective employee. Even when the behavior of the prospective employee does not raise any red flags, the new employer should require the prospective employee to make a representation that he or she has not taken trade secrets or confidential information from his or her former employer and has not violated (and will not violate) any restrictive covenant applicable to him or her.

Employers looking to hire a team of employees from another firm (i.e., a "lift-out") should be cautious in how they do so. While lift-outs are common in the hedge fund industry, they can pose legal problems and cause reputational harm for the new employer if not handled appropriately. For one thing, the hiring of a team will often implicate multiple restrictive covenants, which increases the due diligence and monitoring obligations for the new employer. Second, it is very unlikely that a team that leaves together will not have discussed the move prior to departure, and the prospective team members may have already breached their restrictive covenants or duty of loyalty before commencing discussions with the prospective employer. As a result, fund managers looking to hire groups of employees should do so carefully. It is prudent to first hire a senior employee that is either not subject to restrictive covenants or after his or her covenants have expired. Once the new employee is on-boarded, and clear of continuing non-solicitation obligations, he or she can proceed to approach other employees from his or her former employer to discuss new employment opportunities.