Recent and Upcoming Legal Developments Affecting Employers

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Ian concentrates on executive compensation and employee benefits, with a focus on the employee benefit aspects of mergers and acquisitions and issues arising from the investment of pension plan assets. He represents both executives and companies with respect to the negotiation and drafting of executive employment agreements and advises as to the design and establishment of virtually all types of employee benefit arrangements ranging from cash incentive, equity, deferred compensation and change-in-control arrangements to broad-based retirement and welfare plans. He also advises clients on fiduciary and plan asset requirements of ERISA, including the structure and offering of various securities and securities products; the formation and ongoing compliance of private equity and hedge funds; the administration, management and investment of employee benefit plans; and compliance with ERISA's various prohibited transaction rules and exemptions.

Ian has been recognized as a leading employment and employee benefits attorney by *The Legal 500 United States* and *New York Super Lawyers*. *The Legal 500 United States* noted that he "operates at a very high level across many areas, but brings a particularly unique set of skills to ERISA Title I matters in his representation of private investment funds." Ian recently co-authored "Federal Court Finds Private Equity Funds Liable for Pension Liabilities of Portfolio Company," published in *Pratt's Journal of Bankruptcy Law*, and presented "The M&A Transactional Practice" at Practising Law Institute ERISA: The Evolving World Seminar. An adjunct professor at New York Law School, he is also a member of the Emory Law Alumni Board.

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Ron is co-head of Schulte Roth & Zabel's Employment & Employee Benefits Group. His practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, nonsolicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spinoffs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. Ron also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Recognized by *New York Super Lawyers* and *The Best Lawyers in America* as a leading employment and employee benefits lawyer, Ron is a Fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. He is a former board member for the Lawyers Alliance for New York, which recognized him in 2015 as a "15 Year Circle" honoree, and a former adjunct professor in the New York University School of Continuing Education's Certified Employee Benefits Specialist Program. Ron frequently speaks and writes on employee benefits and employment topics of interest to the human resources and investment management communities. Ron has also presented on recent employee benefits issues for investment managers, ERISA and withdrawal liability estimates. He is the co-author of "Federal Court Finds Private Equity Funds Liable for Pension Liabilities of Portfolio Company," published in *Pratt's Journal of Bankruptcy Law*, and "Update on the New Federal Overtime Regulations and the New York Minimum Wage," published in *Westlaw Journal – Employment*.

Ron received his J.D. from Columbia University Law School, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law prize, and his B.S. from the Industrial and Labor Relations School at Cornell University.

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Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of private equity funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 United States*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments and issues related to fund restructuring and secondary transactions. Recently interviewed by *Private Funds Management* in "Ringing the Changes," Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" to *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

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Holly focuses her practice on the representation of employers in all aspects of employment law and employee relations. She also serves as co-head of Schulte Roth & Zabel's Cybersecurity Group. With a focus on the investment management space, Holly drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; and provides training and conducts investigations. She litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums.

Recognized as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys in the New York Metro Area" by *New York Super Lawyers*, Holly is a member of the Labor and Employment Law Section of the New York State Bar Association. She speaks and writes often about topics of interest to employers in the investment management industry and is a co-author of *Hedge Funds: Formation, Operation and Regulation*, published by ALM Law Journal Press. Holly recently co-authored "Hedge Fund Employee Compensation," which appeared in *Practical Law*, and has contributed articles on arbitration-related topics to *New York Law Journal*. She was interviewed in "Strategies for Preventing and Handling Cybersecurity Threats from Employees," which appeared in *The Cybersecurity Law Report*, and she is also the author of "Effective Client Communication," which appeared in *Labor and Employment Client Strategies: Leading Lawyers on Preventing Litigation, Minimizing Risks and Dealing with Employee Legal Problems*. A much sought-after speaker, she recently served as a moderator for the NYU Center for Labor and Employment Law 68th Annual Conference on Labor.

Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

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Recent and Upcoming Legal Developments Affecting Employers

I. Statutory and Regulatory Developments Require Firms to Rethink Their Agreements with Employees

A. There are recent statutory developments in Connecticut and New York affecting employment agreements. If not carefully drafted, confidentiality provisions may run afoul of these statutes.

1. Connecticut's Statute: On July 1, 2015, Connecticut enacted a law prohibiting employers from barring discussions about wages or punishing employees for discussing wages. Connecticut's law creates a private right of action and does not exclude supervisory employees.

2. New York's Statute: On Oct. 21, 2015, New York enacted a similar law restricting employers from preventing employees, supervisory and nonsupervisory, from discussing information on wages. New York's law, however, permits an employer, in a written policy provided to all employees, "reasonable workplace and workday limitations on time, place and manner" of such discussion. Employer policies must be consistent with standards promulgated by the labor commissioner.

B. The National Labor Relations Board ("NLRB") has also taken action that affects confidentiality agreements.

1. The NLRB filed a complaint against a hedge fund in June 2016. It was settled confidentially in November 2016. The hedge fund was alleged to have an employment agreement and policy that ran afoul of Section 7 of the National Labor Relations Act: The right of employees to engage in "concerted activity … for the purpose … [of] mutual aid and protection."

2. The NLRB challenged five different provisions in the hedge fund's employment agreement:

   (a) Confidentiality of Terms of Employment: "You agree that the terms of your employment with [the firm] are confidential."

   (b) Non-disparagement: "Employees 'may not disparage [the firm] and/or its present or former affiliates, directors, officers, shareholders, employees or clients, whether directly or indirectly, in any manner whatsoever (whether related to [the firm] or otherwise) except as required by law.'"

   (c) Protection of Confidential Information: "Confidential Information" is defined as "any non-public information relating to the business or affairs of [the firm] or its affiliates, or any existing or former officer, director, employee or shareholder of [the firm]," including employee "compensation" information; and information regarding "[the firm's] organizational structure (including the allocation of responsibilities and general construction of [the firm's] departments, businesses, subsidiaries and employees assigned to them)."

   (d) Arbitration Provision Barring Class Actions: "Prohibits employees from pursuing class or collective action, and requires that employees pursue disputes with [the firm] in arbitration on an individual basis."

   (e) Non-publicity: "Employees are prohibited from disclosing 'confidential information' to 'any media or business, outlets, or other endeavors that publish, broadcast, distribute, or otherwise disseminate information in any format, including but not limited to books, newspapers,

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magazines, journals, websites, blogs, social media outlets, television and radio stations, and streaming media outlets.'"

C. The SEC recently challenged employment agreements that allegedly violated SEC Rule 21F-17.

1. Section 21F of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2011 ("Dodd-Frank") provides monetary awards to whistleblowers who provide original information that leads to a successful SEC enforcement action and prohibits employers from retaliating against such employees. Although adopted in 2011, the first enforcement action was publicized in 2015 against KBR.

2. Rule 21F-17 provides that "no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications." Although adopted in 2011, the first enforcement action under Rule 21F-17 was publicized in 2015 against KBR.

   (a) KBR had a confidentiality agreement that employees were required to sign before an internal investigatory interview and required the employees to get authorization from the company's legal department before disclosing information outside of the company. The SEC determined that the provision undermined the purpose of Section 21F and violated Rule 21F-17.

   (b) KBR was required to amend its agreement to expressly provide that nothing in the agreement prohibits an employee from "reporting possible violations of federal law or regulation to any governmental agency or entity" (including the SEC) or from "making other disclosures that are protected under the whistleblower provisions of federal law or regulation."

3. Several publicized enforcement actions in 2016 involved separation agreements.

   (a) The SEC challenged a confidentiality provision that prohibited employees from disclosing confidential information unless "compelled by law and after notice to" the employer.

   (b) The SEC challenged a non-disparagement provision that specifically prohibited former employees from communicating disparaging information about the company to the SEC.

   (c) The SEC challenged provisions in which the employees waived or acknowledged they were waiving the right to any monetary recovery in connection with a complaint filed with a government agency.

   (d) The SEC determined that the provisions undermined the purpose of Section 21F and violated Rule 21F-17.

   (e) The employers were ordered to contact former employees who had signed separation agreements since Aug. 12, 2011 (the date Rule 21F-17 became effective) and to provide them with a copy of the SEC Order and a statement that the employer "does not prohibit former employees from:

      (i) [P]roviding information to, or communicating with, Commission staff without notice to the Company; or

      (ii) [A]ccepting a whistleblower award from the Commission pursuant to Section 21F of the Exchange Act."

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4. On Oct. 24, 2016, the Office of Compliance Inspections and Examinations ("OCIE") sent out a risk alert regarding compliance with Rule 21F-17.

   (a) OCIE is reviewing and examining registrants' compliance with rules impacting whistleblowers and potential whistleblowers.

   (b) In reviewing registrants' compliance with Rule 21F-17, OCIE's staff is analyzing a variety of documents, including: (1) compliance manuals; (2) codes of ethics; (3) employment agreements; and (4) severance agreements.

   (c) OCIE is analyzing whether these documents contain provisions similar to those in agreements that the Commission has found to violate Rule 21F-17, including provisions that:

      (i) "[P]urport to limit the types of information that an employee may convey to the Commission or other authorities"; and

      (ii) "[R]equire departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government."

II. Protecting Your Firm's Confidential Information with Restrictive Covenants

A. Noncompetition agreements and other restrictive covenants are becoming increasingly common. There are a number of issues that arise in the context of drafting and attempting to enforce noncompetition and other restrictive covenant agreements especially in the private funds context.

   1. The law with respect to covenants not to compete varies from state to state. Some states, like California, have laws that prohibit an employer's ability to impose and enforce noncompetition agreements, except in certain circumstances. *See* Cal. Bus. & Professions Code Section 16600.

      California has recently enacted legislation to bolster its statutory prohibition of noncompetition agreements. California Labor Code Section 925 ("Section 925") prohibits employers from requiring an employee who primarily lives and works in California to enter a contract that requires the employee to litigate with his or her employer outside of California or be deprived of the protections of California law.

      (a) Section 925 only applies to contracts entered into after Jan. 1, 2017. Section 925 also does not apply if the employee is represented by legal counsel.

      (b) The law was drafted as a response to concerns over employers imposing choice of law and forum selection provisions on California residents; those who advocated for the law characterized these provisions as attempts by employers to evade California law. *See* Cal. Bus. & Professions Code Section 16600.

   2. In general, restrictive covenants may be used to protect an employer's legitimate business interests, such as extraordinary employee services and trade secrets. Trade secrets can include, but are not limited to, confidential customer information and, in some situations, customer relationships.

   3. In evaluating whether a "trade secret" is protectable, New York courts analyze the following factors:

      (a) The extent to which it is known by employees who do not need to know and others involved in the employer's business;

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(b) The measures the employer takes to guard the information's secrecy;

(c) The value of the information to the employer and its competitors;

(d) The amount of money or effort that the employer expended in developing the information; and

(e) The ease or difficulty with which the information could be properly acquired or duplicated by others. *See Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 554 (E.D.N.Y. 1995).

Connecticut courts look at the same factors, as well as "the extent to which the information is known outside the employer's business." *See Robert S. Weiss & Assoc., Inc. v. Wiederlight*, 208 Conn. 525, 538 (1988).

4. New York courts historically have been reluctant to enforce restrictive covenants in light of the strong public policy in favor of free competition and against restricting an individual's ability to earn a livelihood. Nonetheless, "properly scoped noncompetition agreements are enforceable to protect an employer's legitimate interests so long as they do not militate against public policy." *See Int'l Bus. Mach. Corp. v. Visentin*, No. 11 Civ. 399 (LAP), 2011 WL 672025, at *8 (S.D.N.Y. Feb 16, 2011) (citing *BDO Seidman v. Hirshberg*, 93 N.Y.2d 382 (1999)).

(a) A New York federal court addressed the extent of trade secret protection in a case in which the court denied IBM's attempt to restrain one of its former executives, Giovanni Visentin, from working for an IBM competitor, HP, for one year. *See Visentin*, 2011 WL 672025.

(b) In seeking a preliminary injunction, IBM alleged that Mr. Visentin had acquired trade secrets, including: strategic initiatives in cloud computing, acquisition plans, pricing strategies, operational finances, the identity of troubled accounts, competitive strategies with HP and client "pipeline" information. The court addressed each of IBM's alleged trade secrets and found that Mr. Visentin only had generalized information and that IBM had failed to provide any specific examples of how Mr. Visentin's generalized knowledge could be used at HP to IBM's detriment. The court, therefore, denied IBM's motion for a preliminary injunction.

(c) The lesson for employers from the *Visentin* case is that, to prevail, they will need to explain the precise trade secret information at issue and the adverse impact the disclosure of that information will have on the employer's business.

B. There has been an increase in legislative efforts aimed at limiting the use of noncompetition agreements.

There is proposed legislation in New York that will limit the use of noncompetition agreements. The bill, proposed by New York Attorney General Schneiderman:

1. Bans the use of noncompetition agreements for any employee earning below the salary threshold as set by N.Y. LAB. Law § 190(7) (currently $900 per week);

2. Prohibits noncompetition agreements that are broader than needed to protect the employer's trade secrets or confidential information;

3. Mandates that noncompetition agreements be provided to employees before a job offer is extended;

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4. Requires that employers pay employees additional consideration if they sign noncompetition agreements;

5. Limits the permissible time duration for noncompetition agreements; and

6. Creates a private right of action, including liquidated damages for violations.

C. There has also been unprecedented regulatory action by New York Attorney General Schneiderman against companies that imposed noncompetition agreements on a broad range of employees. Three actions have resulted in settlements:

1. Examination Management Services Inc. ("EMSI"), a nationwide medical information services provider, had noncompetition agreements that prohibited all employees from working for competitors after leaving the company, regardless of whether they had access to trade secrets. A former EMSI employee filed a complaint after a prospective employer refused to hire the former employee when it discovered the EMSI noncompetition agreement.

   (a) Under the settlement agreement, EMSI will no longer require New York employees other than "top executives such as directors and officers" to sign noncompetition agreements.

   (b) Pursuant to the settlement agreement, EMSI notified current employees and former employees who left within the last nine months (the restricted period under the agreement) that the noncompetition agreement was no longer in effect.

2. Law360 owned by Portfolio Media, Inc. ("Law360") had noncompetition agreements with a majority of its employees. The agreements mostly covered editors, reporters and researchers. A former employee would be banned from working for "any media outlet that provides legal news" for one year after termination of employment.

   (a) Under the settlement agreement, editorial employees will no longer be required to sign noncompetition agreements "except for a small number of top executives."

   (b) Under the settlement agreement, Law360 agreed to notify all current and former employees who left within the past year (the restricted period under the agreement) that the noncompetition agreements were no longer in effect.

3. Jimmy John's Gourmet Sandwiches ("Jimmy John's"), a sandwich franchisor, included sample noncompetition agreements in hiring packets sent to franchisees. The sample noncompetition agreements were intended for "sandwich makers" and "delivery drivers," who were prohibited for two years after leaving a job with a franchisee, from working at any establishment within two miles that made more than 10 percent of its revenue from sandwiches.

   (a) Under the settlement agreement, Jimmy John's agreed to stop including sample noncompetition agreements, and also agreed to inform franchisees "that the Attorney General has concluded the non-compete agreements are unlawful and should be voided."

   (b) Franchisees that had been using the noncompetition agreements promised to void past agreements and discontinue their use.

4. Attorney generals of other states have also challenged noncompetition agreements. For example, Illinois' Attorney General Lisa Madigan reached a similar settlement with Jimmy John's.

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III. Enforcement Mechanisms and Remedies for Breaches of Your Agreement's Restrictive Covenants

A. Generally, restrictive covenants in New York will be enforced when necessary to prevent a former employee from engaging in unfair or illegal competition through the disclosure or use of trade secrets or confidential information.

1. To be enforced, restrictive covenants must be reasonable in time, duration and scope. The case law concerning restrictive covenants is highly fact specific. Generally, restrictive covenants in New York will be enforced only:

(a) To the extent necessary to prevent a former employee from engaging in unfair or illegal competition through the disclosure or use of trade secrets or confidential information; or

(b) When the employee's services are unique or extraordinary. *See Reed, Roberts Assoc., Inc. v. Strauman*, 40 N.Y.2d 303, 307, 353 N.E.2d 590, 593, 386 N.Y.S.2d 677, 679 (1976); *Ivy Mar Co. v. C.R. Seasons Ltd.*, 907 F. Supp. 547, 554 (E.D.N.Y. 1995).

2. Injunctive relief tends to be the favored remedy because damages are difficult to ascertain with the degree of certainty that is required for an award. *See Estee Lauder Companies Inc. v. Batra*, 430 F. Supp. 2d 158 (S.D.N.Y. 2006).

(a) An employer's remedies are not limited to injunctive relief, however. Monetary damages are available. An employee's breach of a noncompetition agreement is properly measured by lost profits. *See, e.g., Earth Alterations, LLC v. Farrell*, 800 N.Y.S.2d 744 (2d Dep't 2005).

(b) In New York, an employer seeking an injunction to enforce a noncompetition agreement must prove:

(i) A likelihood of success on the merits;

(ii) Irreparable injury to the employer if injunctive relief is not granted; and

(iii) The balance of hardships favors the employer. *See Visentin* (citing *Lusk v. Vill. of Cold Spring*, 475 F.3d 480, 485 (2d Cir. 2007).

(c) Employers should be careful when considering hiring a prospective employee who has an enforceable noncompetition agreement with a former employer. To make out a valid claim for tortious interference with a contract, the former employer must demonstrate:

(i) Existence of a valid contract between the employee and the former employer;

(ii) The competing employer's knowledge of the restrictive covenant. *See Novus Partners, Inc. v. Vainchenker*, 32 Misc.3d 1241(A) (Sup. Ct. N.Y. County 2011 (holding that a former employer adequately alleged that the competing employer had knowledge of prospective employee's noncompetition agreement);

(iii) Intentional procurement by the competing employer. *See Innovative Networks, Inc. v. Young*, 978 F. Supp. 167 (S.D.N.Y. 1997) (holding that the former employer must demonstrate that employee would not have violated restrictive covenant but for the defendant); and

(iv) Actual breach of the noncompetition agreement and damages.

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B. Congress enacted the Defending Trade Secrets Act ("DTSA") in May 2016. The DTSA provides employers with a private cause of action for misappropriation of trade secrets in federal court. The private cause of action does not preempt or displace state law governing the protection of trade secrets.

1. The employer, owning a trade secret "related to a product or service used in, or intended for use in, interstate or foreign commerce," has the right to commence a civil action in federal court if such trade secret is misappropriated or if misappropriation is threatened. There are three principal remedies under the DTSA:

(a) *Ex Parte* Seizures: In "extraordinary circumstances," a court may, upon *ex parte* application, "issue an order providing for the seizure of property necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action." Before issuing such a seizure order, an applicant must demonstrate to the court that the applicant otherwise would suffer irreparable and immediate injury.

(b) Injunctions: An employer may seek an injunction to prevent actual or threatened misappropriation. The DTSA places certain limitations on such injunctions. Most importantly, they may not "prevent a person from entering into an employment relationship." Further, any conditions on employment cannot be based on a person's mere knowledge of trade secrets (unlike employment conditions imposed under state law based on the inevitable disclosure doctrine). Rather, employment restrictions must be based on "evidence of threatened misappropriation."

(c) Damages: An employer may seek damages for actual loss, plus any unjust enrichment in excess of actual loss, caused by the misappropriation of a trade secret. Alternatively, an employer may collect a reasonable royalty for an unauthorized disclosure or use of a trade secret.

2. The DTSA provides employers with greater resources to protect trade secrets. Because the private cause of action under the DTSA will not preempt state law, employers will be able to pursue claims under both federal and state law. They will have access to federal courts to pursue those claims.

3. At the same time, the DTSA imposes additional burdens on employers. Employers will need to make sure that their employment contracts contain the proper notifications as required by the DTSA, which includes providing employees notice of the immunity and anti-retaliation provisions of the DTSA.

   For example, the DTSA provides immunity from civil and criminal liability under federal or state trade secret law for individuals who disclose trade secrets in confidence to federal, state or local government officials, or to attorneys, in each case "solely for the purpose of reporting or investigating a suspected violation of law," or in court filings made under seal.

C. A forfeiture-for-competition provision is a common way to disincentivize competition after termination of employment.

1. The "employee choice" doctrine is based on the assumption that one who elects to leave an employer makes a knowing, informed choice between forfeiting a certain benefit by competing with the employer or retaining the benefit by refraining from competition with the employer. "New York courts will enforce a restrictive covenant without regard to its reasonableness if the employee has been afforded the choice between not competing (and thereby preserving his benefits) or

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competing (and thereby risking forfeiture)." *See Lucente v. Int'l Bus. Mach., Corp.*, 310 F.3d 243, 254 (2d Cir. 2002) (holding that the employee choice doctrine can apply to deprive an employee of a future benefit or to recover a benefit already paid to the employee).

2. A forfeiture-for-competition provision does not prohibit competition. Rather, it provides that if the former employee does compete, he or she will forfeit benefits or payments to which he or she would otherwise be entitled.

3. It is settled in New York that an employer can rely on the doctrine only if: (1) the employer "can demonstrate its continued willingness to employ the party who covenanted not to compete"; or (2) the employee is not discharged without cause. *Id; see also*, *Gismondi, Paglia, Sherling, M.D., P.C. v. Franco*, 104 F. Supp. 2d 223, 233 (S.D.N.Y. 2000); *In re UFG Intern., Inc. v. DeWitt Stern Group, Inc.*, 225 B.R. 51, 55 (S.D.N.Y. 1998) ("[A]n employee's otherwise enforceable restrictive covenant is unenforceable if the employee has been terminated involuntarily, unless the termination is for cause"). *See also Post v. Merrill Lynch*, 48 N.Y.2d 84 (1979) (holding forfeiture-for-competition clauses unenforceable in the event of an involuntary "without cause" employment termination).

4. Employers may want to consider crafting a forfeiture-for-competition clause (sometimes couched as a "good leaver" provision), which permits employees who resign, but do not compete (or engage in other detrimental conduct), before deferred payments are due and/or become vested will be able to receive those payments. If, however, they compete or engage in detrimental conduct before the payments vest and/or become vested, the payments are forfeited. The payments may be substantial enough effectively to deter the employee from competing until they are paid.

IV. A Legal Perspective on Trends in Compensation

A. The postponement or deferral of employees' compensation is a common compensation tool among all types of employers, particularly for asset managers. Its use includes:

1. Incentivizing employees over a multiple-year period;

2. Retaining employees by conditioning payment on continued employment and/or performance;

3. Providing employers with a means to incentivize employees to avoid "bad behavior" (such as violating firm policies and legal requirements) during employment; and

4. Providing employers with a "self-help" means to help impose adverse consequences on an employee who does not satisfy his or her post-obligations to the employer without the need of a court.

B. With the loss of the traditional offshore fund deferred fee arrangements as a result of Sections 409A and 457A of the Internal Revenue Code (the "Code"), the alternatives for postponing "unvested" employee compensation have become more limited. Postponing compensation has been accomplished through two approaches:

1. Postponement on a pre-tax or tax-deferred basis of a portion of an employee's bonus, which requires the firm's partners to pay tax on the amount it is not currently paying; or

2. An after-tax mandatory reinvestment by the employee of a portion of his or her bonus in the funds managed by the firm (i.e., the firm receives a tax deduction and the bonus is taxable to the employee).

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C. Traditionally, certain management firms organized as a partnership incentivized and rewarded successful employees with admission to the partnership. Where employees are granted partnership interests in a firm, it is important to consider how it will affect their status as employees. In most cases, regardless of the size of the partnership interest or whether a capital or profits interest, the individual will need to be treated as a partner for tax and employee benefit plan purposes. In May 2016, the IRS issued temporary regulations clarifying that an individual cannot be both a partner of a partnership as well as an employee of the partnership's subsidiary if that subsidiary is a tax disregarded entity (i.e., an entity that is essentially ignored for tax purposes). The regulations became effective on Aug. 1, 2016.

1. Note, this issue is not relevant where an individual is awarded an equity interest (e.g., a carried interest) in another entity, such as a general partner of a fund or a fund.

2. The consequence of being considered a partner, rather than an employee of an entity, is significant.

(a) Amounts received by a partner for services are not subject to federal income tax withholding; instead, the partner is responsible for the payment of his or her taxes.

(b) Instead of FICA (Social Security and Medicare taxes), which is generally split evenly between an employer and employee, a partner is solely responsible for the payment of self-employment taxes (SECA), which parallels FICA.

(c) A partner is exempt from federal unemployment taxes and is not eligible to make a claim for unemployment benefits.

(d) A partner can participate in employer group health plans but must pay premiums with after-tax dollars and is not eligible to participate in an employer cafeteria plan, dependent care flexible spending account or health flexible spending account.

V. Other Statutory and Regulatory Developments Impacting Your Employees' Compensation

A. A bill pending New York City Council approval will prohibit employers from asking job applicants about their salaries or using volunteered information if they obtain it.

The impetus for this proposed law is gender equality. According to the New York City Council, adopting measures like this bill can reduce the likelihood that women will be prejudiced by prior salary levels and help break the cycle of gender pay inequality.

B. A new Department of Labor ("DOL") overtime rule was blocked by a federal judge in November 2016. The DOL's final rule increased the minimum salary level necessary to qualify for the executive, administrative and professional exemptions under the Fair Labor Standards Act.

1. In May 2016, the DOL issued a final rule that increased the salary level for the executive, administrative and professional exemptions from $455 per week ($23,660 per year) to $913 per week ($47,476 per year) and the minimum salary level for the exemption for "highly compensated employees" from $100,000 to $134,004 per year. The final rule did not change the duties tests for the executive, administrative and professional exemptions or the minimal duties test for "highly compensated employees."

2. The new rule would have gone into effect on Dec. 1, 2016. A federal court in Texas issued a nationwide injunction, preventing the rule from taking effect on Dec. 1, 2016. However, on the same day the new rule was set to go into effect, the DOL filed a notice of appeal. The Fifth Circuit agreed to accelerate the DOL's appeal. It will not be decided until after Jan. 20, 2017.

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3. For New York employers, the injunction means that, for the time being, the minimum salary necessary to qualify for the "highly compensated employee" exemption will remain at $100,000 and at $455 per week for the professional exemption. New York, however, has always required a higher minimum salary threshold for employers that use the executive and administrative exemptions.

4. In conjunction with New York's minimum wage increase that took effect on Dec. 31, 2016, the New York State Department of Labor recently increased the minimum salary thresholds for such exemptions. Similar to the minimum wage increases, the salary thresholds depend on employer size and location.

   Large employers in New York City (11 or more employees):

   (a) $825 per week ($42,900 per year) on and after Dec. 31, 2016.

   (b) $975 per week ($50,700 per year) on and after Dec. 31, 2017.

   (c) $1,125 per week ($58,500 per year) on and after Dec. 31, 2018.

C. New York Labor Law § 195-4.5(e)-(g) prohibits an employer from deducting an employee's wages, including for the purpose of assessing penalties to employees who cause their firms to incur regulatory fines. State laws are an important consideration in designing and enforcing clawback provisions. Clawbacks involve policies in which compensation is recouped by the employer in the event that an employee violates the law, a contract or a policy.

1. New York, for example, prohibits employers from deducting "wages" or requiring that employees pay back their employer for fines they incurred. New York Labor Law § 195-4.5(e)-(g) prohibit an employer from deducting an employee's wages including "repayment of employer, including … fines or penalties for tardiness, excessive leave, misconduct … ."

   (a) Wages are defined under N.Y. Labor Law § 190(1) as the "earnings of an employee for labor services rendered, regardless of whether the amount of earnings is determined on a time, piece, commission or other basis. The term 'wages' also includes benefits or wage supplements." The terms "benefits or wage supplements" is defined as "reimbursement for expenses; health, welfare and retirement benefits; and vacation, separation or holiday pay." N.Y. Labor Law § 198-c.

   (b) "Incentive compensation … not included in the definition of 'wages' under Labor Law § 190(1)" *See Marsh v. Prudential Sec.*, 1 N.Y.3d 146, 154 (2003). This includes deferred equity based compensation such as unvested, contingent rights to equity-based compensation. *See Guiry v. Goldman, Sachs & Co.*, 31 A.D.3d 70 (1st Dept. 2006).

   (c) Another exception to the broad definition of "wages" would be a truly discretionary bonus. Employers must consider what forms of incentive compensation should be included in their clawback policy so as not to violate state law.

2. Employers should consider the various tax implications in designing and implementing clawbacks.

   (a) Under the "Claim of Right Doctrine," if a taxpayer receives compensation that he or she is free to use and dispose of, he or she must pay taxes on this income despite it being subject to some restriction (e.g., violating a clawback provision) that would force the employee to pay back the income in the future.

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(b) Under Section 1341 of the Code, a taxpayer can claim a deduction the following year if the taxpayer establishes that: (i) the income was included the previous year; (ii) after the close of the prior year, he or she did not have an unrestricted right to the income; and (iii) he or she is eligible to a deduction in excess of $3,000 under another section of the Code. However, the "Claim of Right Doctrine" is generally difficult to assert in the context of a clawback.

(c) Because of the adverse tax consequences (on top of the detriment to the employee of repaying the compensation), many employers require repayment of only the after-tax value of the compensation.

(d) Clawback provisions must be designed to avoid violating the strict rules regarding deferred compensation imposed by Code Section 409A ("409A"). 409A prohibits accelerating deferred compensation. If deferred compensation is distributed early to the employee or offset for purposes of satisfying the employee's obligation to repay other monies, this distribution will likely be deemed an "acceleration" or impermissible offset that will violate 409A. 409A provides that a 20-percent penalty or offset is triggered against an employee on all deferrals under the plan.

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