

PRACTICE MANAGEMENT

Keeping Them On Your Side

Here's how to defend your practice from your own employees

BY THOMAS D. GIACHETTI

YOU RUN A financial advisory shop with a roster of happy and satisfied clients. You think their loyalty is to your firm and that they'll be unlikely to leave if any of your key employees depart and set up their own advisory business across town. You may be correct in this assumption, but only if you have protected your business. Here is the sorry tale of one advisor who didn't, and a look at what he should have done to stave off trouble. While the case is hypothetical, it is based on several real-life stories.

Jack, a successful entrepreneur, is the sole shareholder of Jack's Investment Management. Jack formed the firm in 1988, and had overseen the growth of its assets under management from \$20 million in 1988 to more than \$700 million by 2003. Over the years, Jack had also watched his firm grow from just himself and an administrative assistant to 17 employees, including two senior portfolio managers—Mark, who joined the firm in 1997; and Donna, who signed on in 1998—plus Bill, the chief operating officer and compliance officer, who was hired in 1999.

By 2002, Jack's day-to-day involvement in investment management decisions, operations, and client relations had gradually passed to Mark, Donna, and Bill. Although they were well paid, all wanted to become owners in the firm. Mark, Donna, and Bill thought that ownership would demonstrate Jack's commitment to them as well as their own commitment to the business.

Jack refused to budge. Since 2000, he been reading about acquisitions in the investment management industry and perceived that his firm might be a good takeover candidate.

By 2002 he was in his mid-50s and had begun to receive indications of interest in buying the firm from larger investment management and financial services firms. Mark, Donna, and Bill remained unaware of Jack's interest in selling to outsiders and continued to express their desire to become owners.

In February 2003, Jack appeared to have a change of heart, indicating to the key employees that he would consider the sale of minority interests in Jack's Investment Management at year end. But long before December rolled around, Jack received an attractive indication of interest from a larger investment advisory firm—let's call it Successful Asset Management. Starting with Successful's first feeler in May, discussions progressed in secret over the next few months. By mid-August, Jack had entered into a letter of intent to sell his shop, pending due diligence and execution of a final contract within 90 days, at a price that far exceeded his expectations.

A Sense of Betrayal

A few days after inking the letter, Jack advised Mark, Donna, and Bill of his plan to sell out. They felt betrayed: Mark, Donna, and Bill had been looking forward to becoming minority owners, with the hope that over time Jack would sell them his majority share. Over the following weekend, the trio met twice to discuss Jack's news. They determined to form MDB Investment Consultants, their own registered investment advisor, and leave Jack's firm by October 15.

During the next month, Mark, Donna, and Bill moved quickly: engaged competent securities legal counsel to register MDB as an investment advisor; made arrangements with a custodian; rented office space; and made



Illustration: Alex Nabaum

other practical arrangements so as to be well prepared for their pending exit.

Fast forward to October 3. Mark, Donna, and Bill march into Jack's office and announce that they are resigning from his firm that very day. They arrive at the new offices of MDB the same afternoon and begin calling clients they had served and socialized with while working for Jack, informing them that they had hung out their own shingle. Many of the clients tell Mark, Donna, or Bill to transfer their accounts to MDB. By the end of October, \$300 million in assets has shifted from Jack's to MDB.

Jack didn't take the former employees' raid on his business lightly. When he first received word that clients were moving to MDB, Jack asked his attorney to go to court immediately and stop Mark, Donna, and Bill from "stealing his clients" and "ruining his business." But Jack was rebuffed. Moreover, Successful Asset Management indicated that it might not proceed with the purchase of Jack's firm—and if it did, the deal would most definitely be on drastically less favorable terms to reflect Jack's smaller asset base.

A Fatal Error

Did this train wreck occur because Jack failed to make Mark, Donna, and Bob shareholders of his firm? No. Jack's fatal error was that he never required Mark, Donna, and Bill to sign a "restrictive covenant agreement." Such an agreement would have prohibited or restricted the trio's ability to divert client accounts from Jack's to MDB either if their employment was terminated or they voluntarily decided to quit. Indeed, a restrictive covenant agreement could even have contained a provision requiring Mark, Donna,

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and Bill to pay monetary compensation to Jack's in return for their ability to shift clients' accounts to their new firm.

Generally, there are two types of agreements that an investment advisory firm can require its employees to execute:

Non-competition. In this type of agreement, a firm generally seeks to prohibit the employee from accepting employment in the investment advisory/financial services industry for a certain period of time. A non-competition covenant can be modified to limit the restriction by geography, such as a ban on accepting employment for a period of two years in particular states or within a 100-mile radius of the firm's offices.

Non-solicitation. In this agreement, a firm does not seek to prohibit the employee from accepting employment in the same or similar industry. Rather, it generally seeks to prohibit the employee for a certain period of time either from soliciting or providing services to firm clients, no matter where they may be. The non-solicitation covenant can be modified to limit or expand the client prohibition to past and current clients as well as prospective clients reasonably identified by the firm prior to the employee's departure.



Thomas Giachetti

Both types of restrictive covenants are intended to protect a company's legitimate business interests and, most important, its client relationships. The primary difference is whether the employee will be prohibited from seeking or accepting employment in the same industry, or will be permitted to become employed in the same industry, but not with the benefit of the firm's clients or employees.

I favor the latter type of agreement: the non-solicitation covenant. Certain states generally look unfavorably upon or prohibit non-competition covenants based upon the principle that it is contrary to public policy to bar an individual from making a living in his or her chosen profession. Thus, if the enforceability or reasonableness of the non-competition covenant could potentially be challenged, the firm is better off seeking a reasonable non-solicitation covenant that is generally more enforceable.

In addition to the type of restrictive covenant, a properly drafted agreement

should also include a confidentiality provision in which the employee is bound to keep confidential all firm information, such as client data or proprietary investment processes or technology, and not to use any of this for any purpose other than for the benefit of the firm. In addition, the confidentiality covenant should also require any employee who maintains or has access to any of the firm's confidential information outside of the firm's offices to return all such information to the firm upon departure.

Finally, the agreement should provide the firm with adequate legal recourse against the employee if he or she violates the non-solicitation covenant or confidentiality provisions. This includes the ability to immediately request that a court issue a restraining order to enjoin the former employee from violating the agreement or to recover monetary damages.

The best time to have an employee execute the agreement is immediately prior to beginning employment or, at least, when the employee starts on the job. If a prospective employee declines to execute the agreement, don't hire him.

A properly prepared agreement with reasonably drafted non-solicitation and confidentiality covenants only asks the new employee, at the inception of the employment relationship, to agree not to steal from the firm by recognizing its legitimate proprietary interest in protecting client relationships and business operations. But what about a new employee who brings clients along with him to the new job? It is not unusual to exclude those pre-existing client accounts, in a schedule to the agreement, from the non-solicitation covenant. However, unless there are unusual circumstances, the agreement should also make clear that any new clients that the new employee subsequently brings into the firm are the firm's clients and are subject to the non-solicitation covenant.

Is it too late if you did not have the employ-

ee execute the agreement upon joining the firm? No—but you should not present the agreement to an existing employee without first ascertaining whether the state in which the employee is located is a “consideration” state. If this is the case, you may have an agreement that is unenforceable.

In these states, the employer must provide adequate consideration to the existing employee for the employee's non-solicitation covenant to be enforceable. The employee's continued employment is not considered adequate consideration in these states. Depending upon the state, adequate consideration could be a raise, bonus, or promotion. I generally prefer a one-time execution bonus so that the employee cannot later attempt to use an “insufficient consideration” defense to enforcement of the agreement, claiming that she was due a raise and promotion in the ordinary course of her employment. Even in “continued employment” states, I recommend that the firm consider providing the existing employee with some type of consideration.

Many principals of investment advisory firms think about the day that they may sell their largest asset—their firm. But as Jack discovered, the firm's most important asset—its client relationships—must be protected. You don't have to suffer the same fate as Jack. If you do not have an agreement in place for your employees, get one. If you do, but are concerned about its enforceability, have it reviewed. If you accomplish this relatively simple task, you will be in a much better position to ensure that your Mark, Donna, or Bill will not leave the firm with your most important asset and place in jeopardy the value of your firm. IA

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