

## Labor, Employment and Compensation Developments Affecting Private Equity Funds, Hedge Funds and Asset Managers

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This is the first of a series of reports on labor, employment and compensation developments affecting firms that manage and invest capital. Whether it is a hedge fund, asset manager or private equity firm, these entities share many of the same characteristics: relatively small groups of highly educated and highly compensated professionals and support staff working closely in stressful environments, with access to and responsibility for large amounts of capital.

In the early years these “firms” characteristically were run by “founders” who eschewed bureaucracy and managed by force of personality and results. Now, as these entities mature and transition to the “second generation,” they are facing a series of challenges in the labor, employment and compensation realm. These challenges can range from publicly hostile “divorces” as groups split off and start independent competitors, to lawsuits brought by disgruntled professionals and staff over compensation or workplace treatment, to the day-to-day issues arising from implementing a more formalized structure. Additionally, portfolio companies owned by these firms may face new issues as unions undertake new initiatives to unionize their workforce or aggressive plaintiffs’ counsel target private equity firms as “deep pockets” in actions arising from their involvement in portfolio companies. Given the amount of money at issue and the personalities involved, we can expect continued growth in these areas.

The purpose of this series of Proskauer Rose reports is to provide principals and advisors to this sector with practical and relevant advice on labor, employment and executive compensation. This inaugural issue addresses cases in which individuals, from a nationally prominent fund manager to a lower level executive, prevailed on claims that at first glance seem unexpected, as well as a pro-employer case in New York State Court involving the forfeiture of unvested equity interests.

As always, we are available to discuss these cases and review any issues, policies or procedures to protect these businesses and firms and help them grow.

## This Report Discusses Seven Cases:

- **Claims for Unvested Equity Compensation Under New York Wage Law (*Guiry v. Goldman, Sachs & Co.*)**. This recently decided New York case involved a terminated employee who claimed that the forfeiture of his options and restricted stock units — following his termination — violated state labor law protecting “wages.” In affirming the dismissal of the employee’s claim, New York State’s Appellate Division, First Department, emphasized that “deferred equity-based compensation of this kind” is not “wages,” but rather “incentive compensation” that rests on the enterprise value of the employer, not the individual services of the employees, and which could be forfeited. *Guiry* is now on appeal, and, if not settled, the Court of Appeals should have an opportunity to provide some much needed guidance. New York’s labor law has been a favored weapon of executives suing on compensation claims, since it provides for recovery of attorneys’ fees and, in some cases, liquidated damages. The *Guiry* decision is a welcome development for asset managers, private equity firms and hedge funds, since the reasoning underlying the case applies to vesting arrangements for profit participations and “carried interests.” [Click here for a copy of the decision.](#)
- **“Boomerang” Indemnity Exposure (*DeLucca v. KKAT Management, LLC*)**. A CDO/CLO fund manager recently won a significant victory in Delaware Chancery Court (Vice Chancellor Strine) seeking advancement of legal fees incurred in defending a “lift out” action brought against her in New York by her former employer. The portfolio manager had resigned her employment and started a new company, and was shortly joined by a number of her former subordinates from her prior firm. Shortly thereafter she was sued by her former employer and turned around and sought advancement from an affiliate of her former employer for her legal fees in defending the lawsuit. Given the holding in *DeLucca*, advisors and managers should consult with counsel and, if necessary, review and revise their indemnification/advancement provisions. [Click here for a copy of the decision.](#)
- **“Protected Activity Challenging Compensation Policies” (*Citizens Investment Services Corp. v. NLRB*)**. This case involved the affirmance by the United States Court of Appeals of a finding by the National Labor Relations Board that a financial consultant for a money manager, who was fired for questioning compensation policies, was protected under Federal labor law. This sort of finding, in a non-union setting, is likely not to be expected by asset managers; however the broad scope of the Federal labor laws must be considered when disciplining employees who may be engaged in protected “concerted activity.” [Click here for a copy of the decision.](#)
- **Section 306 of the NLRA and “Neutrality Agreements” (*Patterson v. Heartland Industrial Partners, LLP*)**. In *Patterson*, a private equity firm (Heartland) was engaged in the business of acquiring underutilized manufacturing plants in the Midwest that it thought could again be made profitable. Consistent with new methods by unions to engage in “top down” organizing, Heartland entered into a series of neutrality agreements with the United

Steelworkers promising “neutrality” and cooperation in membership organizing drives at its portfolio companies. After Heartland acquired an additional plant, and the union attempted to organize there, the drive was met by active resistance by certain plant employees, some of whom filed suit in Federal court claiming the neutrality agreement violated Section 302 of the Labor Management Relations Act, which prohibits an employer from granting a union certain “things of value.” The Federal Court in the Northern District of Ohio dismissed the lawsuit, finding that the neutrality agreement did not involve any payment, loan or delivery of any tangible thing of value.

- **“Whistleblower Protection” for Raising SEC Violations.** Two recent cases highlight the breadth of the whistleblower provisions of Sarbanes-Oxley Act (“SOX”) and how they can apply to firms involved in the management of capital. First, in *Fraser v. Fiduciary Trust Company, Int’l*, the defendant employer was the subsidiary of a publicly traded investment company, and fell squarely under the whistleblower coverage provisions of Section 806 of SOX. The interesting aspect of this case is the conduct that gave rise to the whistleblower’s claim: giving selective “sell” guidance to clients regarding WorldCom bonds. [Click here for a copy of the \*Fraser\* decision.](#) In the second case, *Klopfenstein v. PCC Flow Techs Holding*, a whistleblower brought a claim against the private subsidiaries of a publicly traded company, and the interesting aspect of the decision is the holding that a private subsidiary could be an “agent” of the public parent for purposes of applying SOX, and the implications that this “agency” concept could have for private equity firms with publicly traded portfolio companies. [Click here for a copy of the \*Klopfenstein\* decision.](#)
- **The Employee Choice Doctrine & Involuntary Termination (*Morris v. Schroder Capital Mngt Int’l*).** This recently published case involves judicial efforts to clarify New York common law and its “employee choice” doctrine, which permits private equity firms and asset managers to use “golden handcuffs” to enforce non-compete and non-solicitation provisions in their operative documents. Whether it involves the forfeiture of “carry” or of a deferred bonus, the basic tenet of this doctrine has been that when an employee resigns and competes, he or she forfeits something of value, and that the reasonableness of the forfeiture will not be examined. But the issue in this case is what standard the courts should use to determine if the employee has left “voluntarily”; a unanimous panel of the U.S. Court of Appeals for the Second Circuit has asked New York State’s highest court (the New York Court of Appeals) to rule whether the “constructive discharge” standard used in federal employment discrimination cases should control or whether some other standard more favorable to the employee should prevail. [Click here for a copy of the decision.](#)
- **Claims for Discretionary Bonuses (*Guggenheimer v. Bernstein Litowitz Berger & Grossman*).** This case involves one of the nation’s leading plaintiff’s securities law firm, but this time as a defendant in a claim by a disgruntled associate for a bonus. Although the case involves a law firm, it is relevant to funds or asset managers, where promises of a bonus are made routinely and there is a course of conduct of paying bonuses in prior years. In this case, the defendant law firm’s motion to dismiss was denied and the claim that an associate had been promised—

orally—a bonus for bringing in business was allowed to go forward. While the amount of the bonus may have been discretionary, there was suitable evidence showing that her entitlement to a bonus was not discretionary, and that she had adequately alleged a claim to go to trial. [Click here for a copy of the decision.](#)

*What follows is a description of these cases, and, where relevant, some practical pointers to deal with the impact of the decisions.*

## I. Equity Compensation and New York Wage Law

[\*Guiry v. Goldman, Sachs & Co.\*, 814 N.Y.S.2d 617, 2006 NY Slip Op 03992 \(1st Dept. May 18, 2006\)](#)

In *Guiry v. Goldman, Sachs & Co.*, New York State’s Appellate Division, First Department, in a 3-2 ruling, held in favor of the employer and dismissed claims by an executive for recovery of unvested options and restricted stock awards under the state’s labor laws. By holding that these claims were for “incentive compensation” and not wages, the Appellate Division provided employers with some needed guidance and restrictions of the scope of a New York labor law that had been used by terminated executives to exert leverage by claiming compensation as well as attorneys’ fees and liquidated damages.

The Guiry discussion is important because its reasoning applies to the range of “incentive compensation” arising in the world of hedge funds, asset managers and private equity firms — “carry,” “profit participation” in fees, and bonuses tied to assets under management. In evaluating the employee’s claim, the court in *Guiry* looked to the seminal New York Court of Appeals’ decision in *Truelove v. Northeast Capital & Advisory, Inc.* The plaintiff in *Truelove* had brought a wage claim against his former employer seeking the remaining installments of his bonus — installments which his employer claimed that he had forfeited by virtue of his termination of employment. The Court of Appeals held that because (1) the employer had discretion in whether or not to make the award and (2) because the bonus was based, at least in part, on firm-wide performance, a factor falling outside of the scope of the employee’s actual work, the bonus was incentive compensation (and not protected “wages”) and therefore forfeiture of such compensation was not prohibited by the New York labor law.

Relying on *Truelove*, the majority in *Guiry* found that the restricted stock units and options constituted incentive compensation because (1) their function was to incentivize the employee to stay with the firm and to maximize the firm’s value, rather than compensate the employee for his actual work, and (2) their value was tied to a factor falling outside out of the scope of the employee’s actual work (*i.e.*, the firm’s stock price).

The case is now on appeal to New York’s highest state court (the Court of Appeals) and, if not settled, that Court will have an opportunity to provide definitive guidance on the extent to which “incentive compensation” falls outside of the State’s labor laws.

## *Guiry's Lessons*

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- The decision in *Guiry* is good news for firms that manage capital, since the hallmark of their compensation arrangements is “incentive compensation,” ranging from allocation of “carry” arising from portfolio companies in the case of private equity firms, to allocation of “carry” on appreciated value in the case of a portfolio manager of a hedge fund, to the grant of profit participations in the management fee revenues or asset-based fees that arise from capital under management. All these incentive arrangements generally have vesting provisions that serve as important retention devices, and *Guiry* holds that enforcing the vesting provision should not result in a violation of New York State labor law. At the same time, employers should still work closely with counsel in reviewing, structuring and implementing their compensation arrangements, and not place too much emphasis on *Guiry* in situations where compensation arrangements have the characteristics of more general commission arrangements tied to the personal efforts of the executive or where incentive cash compensation has been unconditionally awarded for the prior year, since those arrangements still may be protected under New York labor law and are distinguishable from the incentive compensation at issue in *Guiry*.

## II. The Unexpected “Boomerang” Indemnity

### [DeLucca v. KKAT Management, L.L.C., C.A. No. 1384-N \(Del. Ch. Jan. 23, 2006\)](#)

In this case, Joyce DeLucca, a portfolio manager for structured investment funds (the “Katonah Funds”) managed by Katonah Capital, L.L.C. (“Katonah”), was sued by Katonah in New York State court on an alleged “lift out” claim. These cases arise when portfolio managers leave and trigger “key man” provisions in the underlying investment funds that give the investors the right to terminate their investments in the old funds and move them to another manager, possibly even the new entity started by the departing manager. The fund advisor customarily alleges breach of fiduciary duty claims and claims of misuse of confidential information against the fund manager, and may also hold back incentive compensation or bonuses that are claimed to be “forfeited.”

The New York action commenced by Katonah alleged that DeLucca had secretly implemented a departure strategy to trigger the “key man” provisions of the underlying fund documents; based on her departure and as a result of her status as the sole “key man” (or shall we say “key person”) of the funds, investors would have the right to potentially move their assets within the fund to another portfolio manager, which would result in Katonah losing its management fees.

After DeLucca was sued in New York she made a demand for advancement of her legal fees incurred in the New York action under the advancement provisions in the operating documents of various investment entities (the so-called “KKAT entities”) through which she had invested in the underlying funds. The KKAT entities denied the claim and DeLucca sued in Delaware Chancery Court for advancement. The KKAT entities moved to dismiss the Delaware claim on

the grounds that advancement could not possibly be available to DeLuca under the circumstances.

Judge Strine ruled in favor of DeLuca, because the broad advancement provisions under which DeLuca had brought her claim applied to any matter “in connection with or arising out of or relating to” the operation or affairs of the funds. On its face, the New York complaint brought by Katonah emphasized a scheme by DeLuca to trigger the key man provisions of the funds, and further alleged that DeLuca had violated the confidentiality provisions of the investment documents that contained the advancement provisions. Under the circumstances, Judge Strine held that the New York action involved the funds and advancement to DeLuca was required, emphasizing that the KKAT entities could have drafted far more limiting advancement provisions (*i.e.*, stating that advancement and indemnification would not be available for claims brought on behalf of the Katonah Funds against individuals for allegedly violating their duties to the funds or fund managers or with respect to actions outside of their capacity as fund manager).

[Proskauer Rose LLP and Morris, Nichols, Arsht & Tunnell were counsel to Ms. DeLuca in the litigation. All litigation involving DeLuca has been settled.]

### *The Lessons of the DeLuca Case*

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- Right now, and with the assistance of counsel, audit all possible indemnification and advancement provisions in your operative manager, investment and general partner documents. If the coverage provisions are too broad, change them. Be very careful in drafting a complaint against a departing manager or general partner, since the terms of the complaint will govern the extent to which the claim may fall under the terms of the indemnity and advancement provisions.
- In preparing fund documents, make sure that more than one fund manager is identified as a “key man” to avoid vulnerability if fund managers leave.
- Put into place agreements with fund managers that have reasonable advance written notice provisions (*e.g.*, 60 days’ prior written notice) or paid “garden leave” provisions (*e.g.*, six months base salary) in the event a fund manager gives notice. This will permit the fund manager to plan in advance when dealing with departures and their impact on investors.
- Review the forfeiture provisions of any bonus or incentive plans carefully to ensure that they expressly provide for forfeiture of any pro rata bonus or incentive fee in the year of departure, and any unpaid bonus or incentive fee from years prior to the departure. In addition, all deferral arrangements should be reviewed to ensure that forfeiture takes place to the full extent permitted by law.

### III. The National Labor Relations Act and “Protected Concerted Activity” in the Union Context

#### [Citizens Inv. Servs. Corp. v. NLRB, No. 04-1317, \(D.C. Cir. Dec. 16, 2005\)](#)

In this case arising under the National Labor Relations Act (the “NLRA”), the D.C. Circuit Court of Appeals affirmed a ruling by the NLRB that an investment counseling company violated federal labor law by firing a financial consultant when he evidenced protected “concerted activity” by protesting compensation plans proposed for a group of financial consultants. Readers are right to scratch their heads and wonder how federal labor law applies in the non-union setting of an investment advisor. The answer is that the federal labor laws apply to “concerted activity” regarding terms and conditions of employment, even if a union is not in the picture.

In upholding the NLRB’s decision against the firm, the Court of Appeals found that the consultant, Christopher Hayward, had established substantial evidence that he engaged in protected concerted activity, and the company fired him as a result of that activity. Consequently the company was ordered to reinstate Hayward or offer him a position commensurate with his prior position, remove any unfavorable references to the discharge from his personnel files, and make him whole for any losses that he suffered as a result of his unlawful discharge.

The facts of the case are simple, but raise labor law related questions that one may not envision applicable in the non-union world of asset management. In 2001, Citizens Financial Group acquired the commercial banking operations of Mellon Bank, N.A., including the brokerage and investment counseling business of Mellon’s subsidiary, Dreyfus Investment Services Corp. The newly created Citizens Investment Services Corp. (“Citizens”) hired certain financial consultants who had worked for Dreyfus, including Hayward. Hayward and other senior financial consultants (who had no union representation) made critical comments to management in response to drafts and the final version of the commission-compensation plan adopted by Citizens and about improper calculations of commissions.

Hayward was one of the company’s top producers, and, in an April 2002 e-mail to the director of investment sales, Hayward described the “general consensus” among his fellow employees, and in a June 2002 e-mail to the regional sales manager, he jokingly referred to himself as the “union president.” At a quarterly business meeting, Hayward invited the human resources manager to meet with financial consultants and discuss compensation problems, in addition to repeatedly raising these issues during monthly meetings with the regional sales manager.

Importantly, without first taking any lesser disciplinary action against Hayward and in seeming violation of their progressive discipline policy, Citizens fired Hayward in July of 2002, allegedly for openly denigrating the skills of newly hired consultants, criticizing “management integrity,” and making a sale outside his geographic territory. Hayward in turn filed an unfair labor practice charge with the NLRB, which issued a complaint against Citizens. For those not familiar with NLRB procedures, filing an unfair labor charge costs nothing, and, once filed the complainant (in this case Hayward) does not have to expend any funds; the NLRB investigates

the allegations and ultimately determines whether to file a complaint against the employer. If a complaint is filed, the matter proceeds to a trial before an Administrative Law Judge.

Upon review of these facts, the NLRB determined to issue a complaint, and acting within its limited scope of review, the Court of Appeals affirmed the NLRB's action. The relevant evidence established that Hayward was engaged in concerted activity even though he was not designated or authorized to be a spokesperson of the group. Further, the fact that Citizens did not follow its progressive disciplinary policy with a top producer such as Hayward (with no prior disciplinary issues), but abruptly fired him, was evidence that it intended to punish Hayward for his protected concerted activities.

### *Hayward's Lessons*

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- Who would have thought that Federal labor law applied in the highly compensated non-union world of investment advisors? The weakness in Citizens' case is that it strayed from following its standard policies, thereby raising the likelihood that Hayward was being disciplined for concerted activity. Federal labor laws protect "employees," and, to the extent that consultants, advisors and support staff are employees, they can raise claims under the federal labor laws in this type of narrow context—even without a union on the scene.

## IV. Section 302 of the NLRA & Neutrality Agreements

### [Patterson v. Heartland Industrial Partners, LLP, No. 03 Civ. 1596, 2005 U.S. LEXIS 22123 \(N.D. Ohio Apr. 20, 2006\)](#)

In *Patterson*, a private equity firm (Heartland) was engaged in the business of acquiring underutilized manufacturing businesses in the Midwest that it thought could again be made profitable. Heartland believed in "treating organized labor as an economic partner rather than an adversary," and, accordingly, entered into a series of neutrality agreements with the United Steelworkers promising the union cooperation in membership organizing drives. Such cooperation included Heartland's providing the union with the full names and addresses of employees, access to the workplace to conduct the union's campaign, and the company's promise of "neutrality" (*i.e.*, that it would refrain from speaking unfavorably about the union). In exchange, Heartland received the union's agreement to limit its organizing drive to 90 days, not to speak unfavorably about the company during that time, and, in the event the drive was unsuccessful, to regulate the union's conduct at future campaigns. The parties also agreed that, rather than using a secret election to determine whether a majority of employees favored union representation, the union could use a "card check process," whereby the union would collect signed authorization cards from employees. Further, the agreement provided for certain terms of the parties' first collective bargaining agreement if the union were successful, and that *future* companies acquired by Heartland would adhere to the general terms of the neutrality agreement, which would govern organizing drives at those facilities.

In August 2003, Heartland gained a controlling interest in Collins & Aikman Corporation and several manufacturing plants operated by it, including one in Holmesville, Ohio. Thereafter,

pursuant to the terms of the neutrality agreement, the Steelworkers began an organizing drive at the Holmesville plant. The drive was met by active resistance by certain plant employees, some of whom filed suit in federal court claiming the neutrality agreement violated Section 302 of the Labor Management Relations Act, which prohibits an employer from granting a union certain “things of value.” Although the court found that the plaintiffs had standing to bring the suit, and also that a private right of action existed under Section 302, it held that the plaintiffs had not demonstrated that the neutrality agreement itself was unlawful.

In rejecting the employees’ claim that the neutrality agreement constituted a “thing of value” under the statute, the court, relying on a recent Third Circuit decision, observed that “Section 302 . . . proscribes agreements to ‘pay, lend, or deliver any money or thing of value.’ The agreement here involves no payment, loan, or delivery of anything. The fact that a Neutrality Agreement . . . benefits both parties with efficiency and cost saving does not transform it into a payment or delivery of some benefit.” Having found that Heartland’s neutrality agreement with the Steelworkers did not constitute a “thing of value” under Section 302, the court dismissed the plaintiffs’ complaint.

#### ***Patterson’s Lessons:***

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- The decision in *Patterson* is an important one for private equity firms or hedge funds considering the acquisition of companies or plants that might be subject to union organizing efforts. The new approach in union organizing is to avoid secret ballot elections under the NLRB’s standard procedures and instead engage in “top down” organizing efforts, by dealing directly with the “owners” (shareholders) of the business and to use a sophisticated “corporate campaign” to pressure the owners of the business to agree to a neutrality and recognition agreement. These corporate campaigns are very effective at pressuring investors (particularly pension funds) who in turn can have considerable influence on a fund involved in fundraising efforts. Whether this approach is good or bad for the owner, the business and the employees is beyond the scope of this article, but the law governing these arrangements is complicated, and outside labor counsel should be consulted well in advance of dealing with these situations.
- On a related point, the NLRB is currently reviewing a number of cases (involving Heartland and Dana Corporation) that go to the question of how far a union and business can go in agreeing to neutrality and recognition issues, and issues relating to bargaining, before the union actually achieves status as the majority representative of employees in a bargaining unit. (We will keep you apprised of developments in this area).

## V. Whistleblower Status and Sarbanes-Oxley Protection

[\*Fraser v. Fiduciary Trust, No. 04 Civ. 6958 \(S.D.N.Y. February 15, 2006\)\*](#)

[\*Klopfenstein v. PCC Flow Techs. Holding Inc., DOL ARB, No. 04-149, 5/31/06\*](#)

The whistleblower provisions of the Sarbanes-Oxley Act (“SOX”) (Section 806) apply to employees of public companies or the agents of such companies—and the questions of what constitutes a public company under SOX and whether a person or entity is an “agent” of such a public company are complex. The clearest example is a company that is registered under Section 12 of the Securities Exchange Act of 1934, because it trades on a national securities exchange. An example would be a public exchange traded investment company or a portfolio company of a private equity firm that had undertaken an IPO and is traded on a public exchange.

Two recent cases raise interesting questions concerning the application of the SOX whistleblower provisions. The *Fraser v. Fiduciary Trust* case deals with the straightforward application of the whistleblower provisions to a publicly traded asset management firm (Franklin Templeton) and its affiliates. The *Klopfenstein v. PCC Flow Techs. Holdings Inc.* case deals with the application of SOX whistleblower protections to the private subsidiary of a public company, and holds that a private subsidiary may be an “agent” of a public parent, and thereby provides grounds for a claim by a whistleblower employee of the private subsidiary. Given the number of roles that private equity firms play for their portfolio companies—from sitting on the Board, to arranging financing, to orchestrating recapitalizations and restructurings, to monitoring and providing oversight on finance/budget issues—and the fees paid by the portfolio companies for these services, the *Klopfenstein* case raises the interesting question of whether a private equity firm could ever be viewed as an agent of the publicly traded portfolio company and, in that capacity, be subject to a SOX whistleblower claim by its employees who are involved with the public portfolio company.

The key SOX whistleblower issues for our readers are as follows:

1. A protected act under SOX only need involve a complaint by a whistleblower about conduct that s/he “reasonably believes” constitutes a violation of SEC rules or regulations or Federal law relating to fraud against shareholders. The complainant does not have to expressly allege illegal conduct or an express violation of SEC rules or regulations.

2. In *Fraser*, the Southern District Court of New York held that a former executive in an investment company subject to SOX stated a claim under the Sarbanes-Oxley Act’s whistleblower provision that he was illegally fired for complaining about the company’s decision to sell off WorldCom Inc. bonds for its New York pension fund clients but did *not* make the same recommendations to its Los Angeles pension fund clients. While the plaintiff did not in his complaint to management expressly state that the defendants were “engaged in illegal conduct related to fraud on shareholders,” based on the overall context his expressions of his concerns were enough to establish protected activity.

3. In *Klopfenstein*<sup>1</sup>, plaintiff was employed as a Vice President of Strategic Operations for Flow Products, Inc. (“Flow”), one of a number of private business entities owned by PCC Flow Technologies, Inc. (“Holdings”), a non-public company. Holdings was wholly owned by a publicly traded corporation, Precision Castparts Corp. (“PCC”). In late 2002, Klopfenstein noticed that the balance sheets for Flow showed substantially more prepaid inventory in transit overseas than shipping documents reflected. Although he did not think fraud was involved, he thought the data should be corrected because it could affect the accuracy of Flow’s financial statements. The DOL/OSHA Review Board suggested Klopfenstein’s concerns about in-transit inventory suggested, at a minimum, incompetence in Holding’s internal controls that could affect the accuracy of its financial statements; SEC Rule 13a-15a requires public companies to maintain “disclosure controls and procedures” and “internal control over financial reports,” which Klopfenstein cited in his complaint. These complaints, the Board stated, represented communications thus related to a general subject that was not clearly outside the realm covered by SOX, and it was certainly possible that Klopfenstein could have believed the problems were a deficiency amounting to a SOX violation.

### *Fraser/Klopfenstein Lessons*

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- The basic lessons of *Fraser* and *Klopfenstein* derive from the nature of claims raised by employees that relate to financial manipulation or some alleged detrimental action against investors. Once those issues are raised, and before adverse action is taken against any claimant, counsel should be consulted. It is no longer enough to rely on the fact that the claimant has not expressly identified “fraud” or illegal conduct as at issue. In addition, it is no longer safe to simply assume that an employee of a non-public entity cannot bring a SOX whistleblower claim. Under the “agency” approach adopted in *Klopfenstein*, private equity firms (and other firms) that own or control publicly traded entities must now consider whether SOX-type claims apply to them in an “agent” capacity—a determination that only complicates the already difficult task of overseeing a portfolio company or large public investment and driving value for the benefit of investors.

## VI. The New York Employee Choice Doctrine & Involuntary Termination

### *Morris v. Schroder Capital Mngt Int’l*, 05-cv-0823 (2d Cir., April 8, 2006)

In this case, a unanimous panel of the U.S. Court of Appeals for the Second Circuit certified a question of state law to the New York Court of Appeals, concluding that it was unclear how the judges should rule on the issue of whether a former investment banker quit or was “involuntarily terminated” under the New York common law employee choice doctrine. The New York employee choice doctrine provides the legal basis for the “golden handcuff” arrangements that funds and firms use to guard against wholesale departures and competitive activity. Under this

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<sup>1</sup> The Proskauer Rose Client Alert of June 20, 2006, “Privately Held Subsidiaries of a Public Company and Their Employees May Be Liable Under the Sarbanes-Oxley Act” discusses the *Klopfenstein* case in detail (Access it at: [www.proskauer.com](http://www.proskauer.com)).

doctrine, if an employee forfeits compensation and/or equity by voluntarily quitting and engaging in competitive activity, the courts will not question the reasonableness of the forfeiture—the only question is whether the executive left voluntarily.

In the *Schroder* case before the Second Circuit, the plaintiff was a senior vice president and head of domestic equities at Schroder from January, 1997 through April, 2000. During his time with the company, he earned \$225,000 in annual compensation and annual bonuses significantly greater than his salary. Schroder deferred portions of his bonuses each year (and Mr. Morris deferred additional cash portions of his bonuses), which deferred compensation would not vest for three years. Ultimately, the deferred compensation amounted to the \$2.9 million at stake in this case.

The plaintiff subsequently quit and forfeited his deferred compensation. He then sued and alleged that his resignation had not been voluntary, but, instead, he had been “constructively discharged.” In particular, Mr. Morris alleged that over the course of his employment, Schroder had: (1) reduced the amount of assets over which he had responsibility from \$7.5 billion to \$1.5 billion; (2) decided to sell off or reduce support to certain of Morris’ client groups, which would have further reduced the amount of assets over which he had responsibility to only \$800 million; and (3) eliminated the funding for Morris’ U.S. Equity research operation. Mr. Morris alleged that Schroder intended to eliminate his position completely and, in February of 2000, he gave notice of resignation, which was effective April of 2000. At this point, Mr. Morris began a hedge fund in New York which he claimed was not competing with Schroder. Schroder viewed the situation differently and, based on the covenant not to compete in Morris’s employment agreement, determined that Morris had forfeited all of his remaining deferred compensation.

The Southern District of New York analyzed this case under a “constructive discharge” theory, utilizing the standard used in federal employment discrimination cases. Under this theory, to determine whether an employee’s resignation amounted to a constructive discharge by the company, the trier of fact must be satisfied that “the working conditions would have been so difficult or unpleasant that a reasonable person in the employee’s shoes would have felt compelled to resign.” See *Whidbee v. Garzarelli Food Specialties, Inc.*, 223 F.3d 62, 73 (2d Cir. 2000). The court ultimately determined that a reasonable person in Mr. Morris’s shoes would not have found that the working environment was so intolerable that he was effectively forced to leave, specifically noting that Morris “retained the same job title, received the same salary, and received bonuses each year he worked.” The District Court concluded that, under Second Circuit law, “such circumstances are insufficient to create objectively intolerable working conditions.”

On appeal to the Second Circuit, the judges vacated the decision of the District Court on the grounds that the issue of what standard to apply was a question of state law, and that the matter should be certified to the highest state court in New York to be answered. The Second Circuit noted various policy considerations for the creation of the constructive discharge standard are germane to the employment discrimination context, such as to encourage employees to remain employed with their employers while utilizing internal systems to deal with discrimination claims. Whether those same considerations applied in the context of the “employee choice”

doctrine was an open question, and it was possible that New York courts would apply a different, less exacting standard that was more favorable to the employee.

### *Morris's Lessons*

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- The “employee choice doctrine” in New York has been the basis for imposing significant “golden handcuffs” on employees, so that they have to pay serious economic consequences if they quit and move on to competing ventures. In the practical world, the sting of the doctrine has been lessened to the extent that new employers make departing employees whole for any lost economics on a move, but the fact is that the doctrine has been effective in making employees think twice before considering departure. If the New York Court of Appeals were to liberalize the constructive discharge standard, so that employees could claim that they were “forced” to leave and that competitive forfeiture provisions therefore required review under a “reasonableness” standard, employers could be faced with a serious setback in their efforts to protect the integrity of their businesses. In the past employers and employees have dealt with this issue by negotiating “good reason” termination provisions and have carefully delineated those events that would give the employee the right to leave and avoid forfeiture. If the New York Court of Appeals opens the door on this issue, then we can expect employers to require employees to waive any right to assert constructive discharge or where the employees may have some bargaining power employers may try to limit “good reason” termination events in the operative documents to narrowly delineated events (with the employer retaining adequate notice and cure rights).

## VII. Enforcing Claims for “Discretionary Bonuses”

### [Guggenheimer v. Bernstein Litowitz Berger & Grossman LLP, \(N.Y. Sup. Ct. 2006\)](#)

This case stands for the simple point that oral bonus agreements may be enforceable, even with significant discretionary elements. So those who manage firms should be very careful about oral bonus commitments and reduce bonus arrangements to writing whenever possible.

In this case, a former associate sued her old law firm for a bonus arising from referring cases to the firm. In fact, she claimed she took the position at the firm, which paid a substantially lower salary than other similar-sized firms, because she was informed *orally* at her time of hiring that she would be eligible for bonuses for successful class-action cases that she brought to the firm. She also alleged that she was repeatedly told about the firm’s bonus policy after joining the firm. In addition, at weekly firm lunches, a partner allegedly encouraged associates to develop the firm’s business as a means of additional income. Guggenheimer asserted that while she understood that the *amount* of bonus was discretionary, she was never told that her *entitlement* to the bonus was discretionary if certain criteria were met. Further, because she received bonuses for two of the cases she brought in, she argued that she was entitled to a bonus for many other similar cases.

The plaintiff brought her claim in state court in New York City and the court denied a motion to dismiss brought by the law firm. The court noted that, generally, employees do not

have enforceable rights to compensation under discretionary compensation or bonus plans. However, employees may enforce agreements to pay bonuses where such bonuses are “an integral part of plaintiff’s compensation package.” Thus, the issue in *Guggenheimer* was whether she had stated a claim as to the role of bonuses in her compensation package. Specifically, although the firm’s bonus plan may have been discretionary, the court found that there was a question of fact as to whether the firm and Guggenheimer had “an oral contract agreeing to exercise that discretion in plaintiff’s favor.” Of particular importance to the court was the fact that the firm did not refute Guggenheimer’s contention that they had engaged in a “course of conduct” for two years in which they promised a bonus if certain criteria were met. The court found that such a course of conduct could very well create an implied contract, and in that case the firm may have violated both that contract and the covenant of good faith and fair dealing by “destroying the rights of the other party to receive the benefit of the contract.”

### *Guggenheimer’s Lessons*

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- The practical takeaway from this case is to document all compensation and bonus arrangements and to make sure that the document has a standard “integration” clause that states that it supersedes any other oral agreements or understandings and a written modification clause that states that the arrangement can only be modified in writing. This should force any legal claim to be based on the written agreement and help avoid claims based on “oral” promises, after the fact.

### Questions or Comments

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