Hedge Funds Luncheon Series

*Non-Competes: How to Write 'Em and How to Fight 'Em**

(Talent Retention and Recruiting)

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Proskauer

Proskauer's Non-Compete & Trade Secrets Practice Group

- Steve Kayman is the Founder and Co-Chair of Proskauer's Non-Compete & Trade Secrets Practice Group, which includes more than 50 lawyers across four continents.
- The Group advises companies on all aspects of trade secret protection and litigation and non-compete agreements
- The Group assists clients in both litigated and non-litigated matters, in court and in various ADR settings, and provides services that run the gamut from:

  - Day-to-day counseling on the hiring and firing of employees possessing confidential information and client or investor relationships;
  - To counseling and drafting to enhance trade secret management and protection;
  - To drafting confidentiality, non-compete and other agreements and employee handbooks;
  - To high stakes litigation involving claims of employee raiding and theft of trade secrets.

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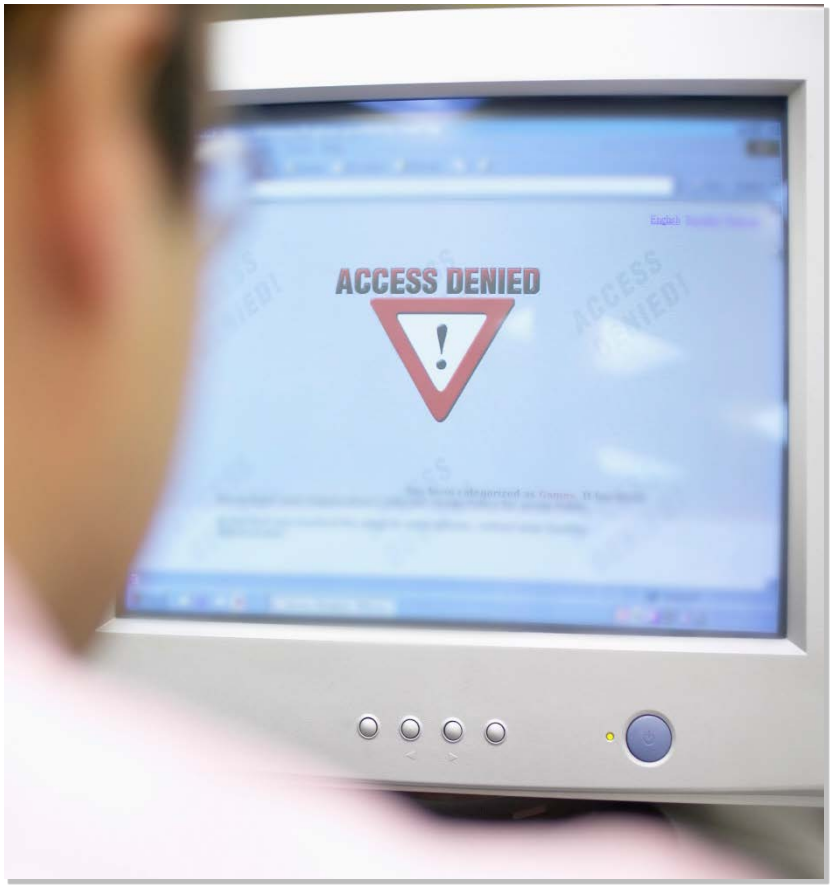
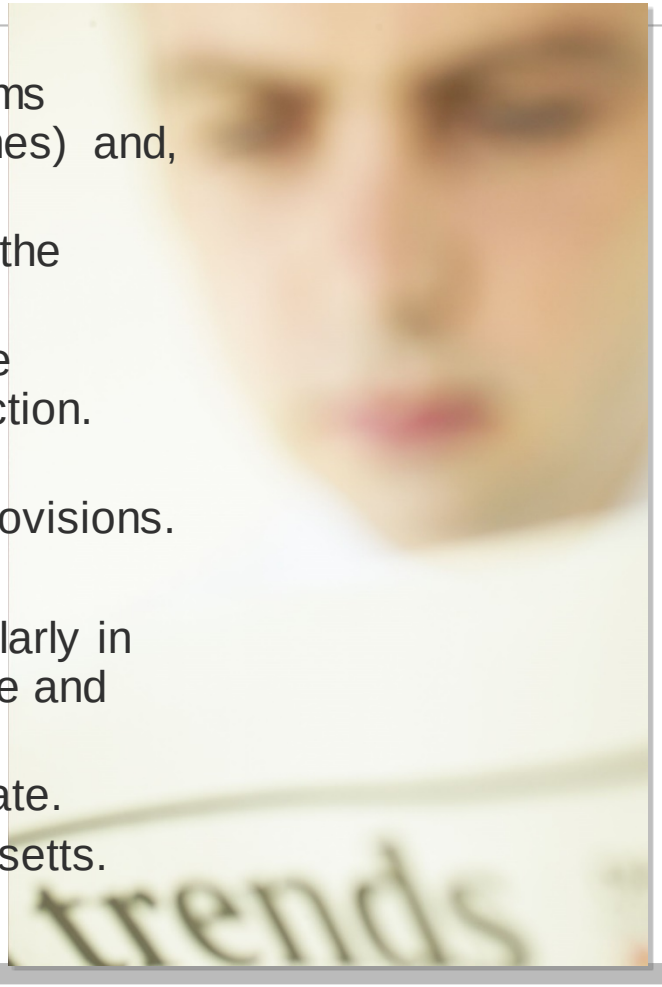
Types of Restrictive Covenants

- Non-competition covenants
- Restrictions on soliciting or dealing with clients, investors and other business partners
- Covenants against soliciting or hiring employees
- Notice before termination ("garden leave") provisions
- Confidentiality and IP acknowledgement/ assignment provisions
- Penalty, forfeiture, claw-back and liquidated damages provisions
- Non-disparagement covenants
- Prohibitions on group departures, often with particularized financial penalties for violations



Trends in Law and Practice

- More litigation, often involving trade secret claims against former employees (especially senior ones) and, not infrequently, their new employers.
- Electronic storage and discovery has changed the nature of litigation.
- More companies, across American industry, are adopting some form of post-employment restriction. Hedge funds have been ahead of the curve.
- More frequent use of notice ("garden leave") provisions.
- More paid non-competes.
- Federal and state prosecutorial actions, particularly in technology and service sectors, against abusive and anti-competitive post-employment restrictions.
- Continued important variations from state to state.
- Much legislative activity, including in Massachusetts.



Clashing Public Policies in IP Law

- Encouraging, rewarding and protecting invention, creation, hard work and business relationships.
- ***Versus*** freedom, fair competition and the preservation of a robust public domain for ideas.
- In the non-compete arena, there's the additional clash between sanctity of contract ***versus*** employee mobility.

Non-Compete Legislation and Reform

- Three states outlaw employment-based non-competes: California, North Dakota and Oklahoma.
- Massachusetts, in August 2018, passed a law requiring separate consideration for most non-competes and forbidding enforcement against lower-level employees and those terminated without cause.
- Other states have imposed durational limits on non-competes or banned or limited their use for junior employees or in certain industries, such as technology, healthcare and broadcasting (not asset management).
- Proposed federal legislation being considered by the Senate and rule-making proposals before the FTC would largely outlaw or severely restrict employment-based non-competes.

Three Basic Types of Claims in the Employee Movement Arena:

1. Breach of non-competes and other contractual restrictions, including compensation forfeitures and claw-backs.

2. Trade secret misappropriation—available remedies under the DTSA and state statutes include recovery of the defendant's gain and reasonable royalties, fee shifting and punitive damages.

3. Breach of duty of loyalty and other legal duties (when employee does bad things before leaving or on the way out).

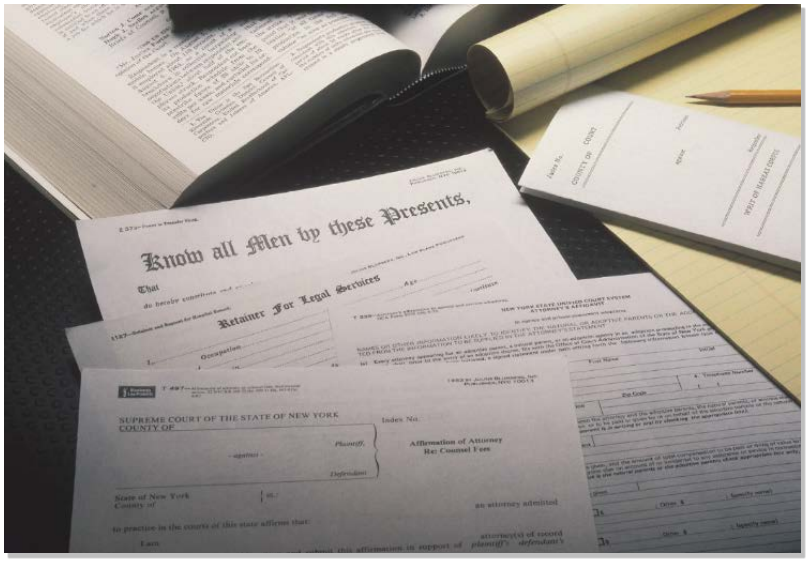
Note: Claims can, and frequently are, asserted against the new employer, often of a derivative nature (inducing, aiding and abetting). But direct claims for tortious interference and misappropriation can also sometimes be asserted against the new employer.

Legal
Restrictions on Employees

- Cannot act disloyally while still employed (Mere Preparation Doctrine)
- Cannot take/retain documents or other employer property when employment ends
- Continuing duty, even after employment ends, not to disclose/use employer's confidential information
- Corporate Opportunity Doctrine

Considerations When Adopting Restrictions on Employees

- Should restrictions be broad or narrow?
- Should a company vary its agreements by type of employee or jurisdiction or should "one size fit all"?
- Types of Agreements
  - Offer letters
  - Comprehensive employment, restrictive covenant and confidentiality agreements
  - Severance and release agreements
  - Employee handbooks and compliance manuals
  - Benefit plans
  - Stock, option and bonus agreements
  - M&A documents
- Watch out for "boomerang" indemnity.



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Former Employer's Enforcement Options

- **Investigate the Departure or Hire Away** – Save all evidence (e-mail traffic; data transfers), catalog all confidential material (and any missing documentation) and lock down the employee's computer (and consider forensic examination of hard drives and phones).

- **Respond in the Marketplace/Conserve the Business** – Consider appropriate level of outreach to clients, investors and other third parties (including, as appropriate, the press and regulators) with a game plan.

- **Solidify Relationships with Remaining Employees.**

Former Employer's Enforcement Options (cont'd)

- **Threatening Letters** – Should include a demand that the former employee and new employer retain all and not destroy any documents, correspondence and other sources of potential evidence; new employers have a duty to preserve potentially discoverable evidence and failure to institute a "litigation hold" may give rise to sanctions or a spoliation inference.
- **Lawsuit** (consider venue, including arbitration)
- **Expedited Discovery**
- **Temporary Restraining Order/Preliminary Injunction/*Ex Parte* Seizure** – Consider risk of an early loss.

Defensive Measures When Hiring From Competitor

- Analyze all contracts before extending a job offer.
- No pre-departure breaches of duty of loyalty.
- No taking/retaining documents (tricky issues surrounding whether/how to return/delete).
- Obtain "representation" letter that employee has not violated duties to former employer.
- Try to avoid "mirror image" responsibilities.
- Keep new hire away from former employer's clients, investors, employees and key vendors (at least for a while).
- Deflect risk of inevitable disclosure through precise instructions and limitations.
- Watch out for disclosure of track record issues, either regulatory or contractual.

Group Departures: Offensive and Defensive Strategies

See the attached article by SMK published April 1, 2015 in *Corporate Counsel*.

- "Lateral recruiting" vs. "raiding" and "lift-outs."
- Groups may leave to form own firm with no new employer involved.
- Key defensive steps include: (i) recruit individually and do not let senior person solicit more junior ones; (ii) no taking/retaining documents; and (iii) no pre-departure solicitation of clients or investors.

SUMMARY

- **Proceed with caution** anytime you hire someone from a competitor, especially if that new employee is subject to a restrictive covenant.
- **There is almost always something** you can do when an ex-employee threatens your confidential information, customer relationships or the stability of your workforce.
- **Consider** whether your company should require some or all of its employees to agree to some form of restrictive covenant; the answer is usually "yes."
- **Examine** employment agreements, employee and compliance manuals, document distribution and computer monitoring practices and employee termination procedures for ways to enhance existing protections for your company's confidential information, IP, client, investor and employee relationships.
- **Unpaid non-competes** are becoming less likely to be enforced as the courts see more paid non-competes.

Selected Hedge Fund/ Employee Movement Cases

- 2020: Hedge fund sued two former employees, who left to establish their own fund, accusing them of misappropriation of trade secrets, breach of contract and unfair competition. An arbitration tribunal found the trade secret claims were brought in bad faith and awarded the two employees $2 million in attorneys' fees and costs. The dispute became public when the employees went to court to enforce the award.
- 2019: SMK case where asset management firm sued former employee (a programmer) alleging misappropriation of trade secrets. Court granted *ex parte* seizure and restraining order resulting in U.S. Marshals Service appearing unannounced at former employee's home and seizing his computers and other electronic equipment.
- 2018: Hedge fund sued former head of human capital and new firm seeking injunction to prohibit them from using confidential information to solicit and hire its employees. Court denied injunction.
- 2016: Hedge fund sued former co-head of data strategy for breach of non-compete provision in employment contract. Parties settled case in a way that allowed former employee to work for new firm.

Selected Hedge Fund/ Employee Movement Cases

- 2015: Hedge fund sued former quantitative software engineer and research analyst who began own firm. Lawsuit sought injunction to prohibit him from breaching his employment contract and to extend non-compete period. Court granted injunction request but refused to extend non-compete period.
- 2012-2015: Co-founder sued hedge fund seeking to invalidate five-year non-compete provision in employment contract. Case settled with firm agreeing to help co-founder set up his own firm.
- 2009-2010: Hedge fund sued three former employees alleging breach of non-compete and theft of trade secrets. Firm won lawsuit and court enforced non-compete clauses.
- 2006: SMK case where portfolio manager left to establish her own firm. Former employer sued in New York, claiming breaches of fiduciary duty and misappropriation of confidential information. Delaware Chancery Court ordered "advancement," requiring former employer to pay the portfolio manager's legal fees in the New York case ("boomerang indemnity"). The case then settled favorably for former employee.

(With thanks to Proskauer Associate Yena Hong for her assistance.)