

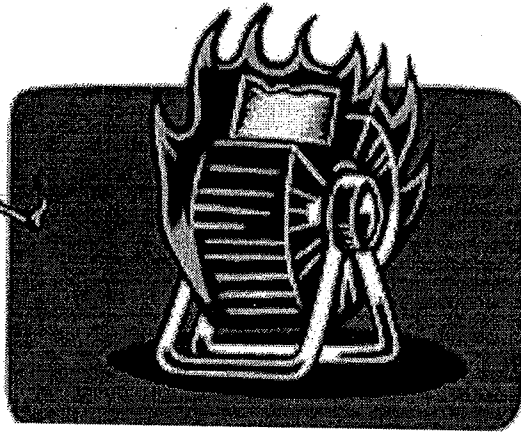
Fire Extinguisher

Nonsolicitation agreements can prevent former partners and employees from decimating your client rolls. But if they're not worded carefully, you could end up getting burned.

Elayne Robertson Demby

TALK ABOUT GOING UP IN flames. A financial adviser planning to sell his firm and retire called Thomas D. Giachetti, a partner in the Princeton, N.J., law firm of Stark & Stark, earlier this year with a problem. Soon after the adviser announced to his staff his plans to sell the firm, two managers left—taking the chief operating officer and compliance officer with them—and another manager made plans to leave. “I need you to restrict them from contacting my clients,” the adviser told Giachetti, who replied that he would need to review the firm’s nonsolicitation agreements. But the adviser never bothered to have any agreements signed. So Giachetti and the adviser could do nothing but watch as former staff members lured away one important client after another. The end result: within three months the firm lost about half of its assets under management, the sale fell through, and the adviser’s succession plan was reduced to ashes.

In any customer-service industry it’s a given that, unless restrained, departing employees and partners may seek to entice clients to leave with them. And a sizable exodus, whether it happens on the eve of the sale of your firm or earlier, can do serious damage. Nonsolicitation agreements, which restrict staff members from seeking business arrangements with firm clients after they leave, are critical for investment-advisory firms, Giachetti says. They can help protect your client base as well as the value of your firm. (See “Good Insulation,” page 48.) Unfortunately, he adds,



advisers often fail to use such contracts. “People go into the advisory business with nothing but a handshake,” agrees Mark Tibergien, a principal at Moss Adams, an industry consultant in Seattle. “But there is a high probability that a business will break up before it is sold.”

Worse still, even when clients and assets depart, liabilities may remain. Tibergien recalls working with two advisory-firm partners who had a falling-out with a third partner. When the third partner ultimately left with 50 percent of the clients, the partnership went under, leaving the two remaining partners more than \$50,000 in debt. They attempted to sue the third partner, but because they never executed a nonsolicitation agreement, Tibergien says, they didn’t have a legal leg to stand on.

Nonsolicitation agreements are often confused with noncompetition agreements, but they’re two separate types of arrangements. Although the two can be included in the same contract, they differ in a number of important ways, including enforceability. A noncompete agreement, for example, prevents a former employee from working in a certain industry, either at all or within a geographic radius. But because courts disapprove of contracts that deprive anyone of the reasonable right to earn a living, they are often reluctant to enforce noncompetition agreements. In some states, such as California, they are never enforceable.

With nonsolicitation agreements, however, former employees are barred only from soliciting business with the

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firm's clients—whether it's for the former staffer's benefit or the benefit of a competitor. "A nonsolicitation agreement doesn't prevent them from plying their trade," says Tibergien, "they just can't do it with your clients." Courts, even those in states such as California, Oregon, and Massachusetts, which routinely invalidate noncompetition agreements, have been more inclined to uphold nonsolicitation agreements, which can also restrain ex-employees from luring away current employees or soliciting business with strategic suppliers and referral partners.

But although nonsolicitation agreements are more likely to be upheld, they're far from a sure bet. So before drafting any document and presenting it to potential or existing staff members, make sure you're familiar with the essential elements of a sound agreement—what should be included as well as what should be avoided. It would also be prudent to have a lawyer review any agreement. The cost for such legal services vary widely around the country, says Randy Sutton, a partner with Saalfeld Greggs, a law firm in Salem, Ore., but for a fairly generic agreement a lawyer will probably charge about \$750. More-customized agreements will of course be more expensive.

Still, customization may be worth considering. Because cookie-cutter agreements are usually difficult to enforce, Giachetti says, make sure you draft a document specifically

tailored to your business model. Start by identifying a specific business justification for the nonsolicitation, such as promoting the stability of the firm or protecting a valuable customer relationship that your business has spent years developing.

Don't make blanket solicitation prohibitions. "If you narrow it to certain clients, then it is more enforceable," says Sutton. He suggests that agreements cover only clients with more than a specified amount of assets under management,

noting that suing ex-employees who take smaller clients is probably not worthwhile. Larger national or regional firms may also be wise to limit nonsolicitation to clients in a specific geographic area, says Richard Agins, a partner in the New York law firm of Agins Siegel & Reiner. If an employee works in the New York office and only has knowledge of New York clients, then preventing him from soliciting clients anywhere in the United States may be deemed unreasonable in court, and the employer may not be able to enforce the agreement.

In fact, for agreements to be deemed enforceable, courts require that the terms be "reasonable" and that employees are given "adequate consideration." In other words, says Sutton, the more lopsided in favor of the employer an agreement looks, the more likely it will be deemed unenforceable. Courts may, for example deem an agreement nonenforceable if the required period for nonsolicitation is

GOOD INSULATION

NONSOLICITATION AGREEMENTS CAN prove to be invaluable when the time comes to sell your business, not only because they help prevent the loss of client assets, but also because they can boost the valuation of your firm.

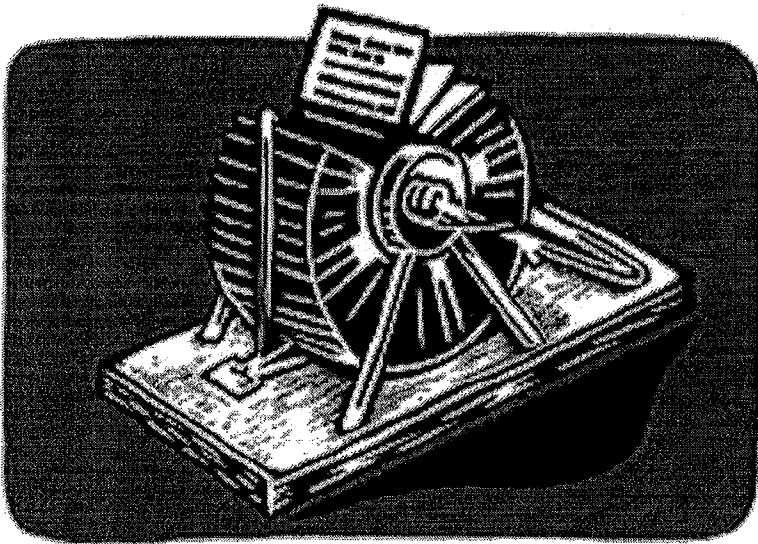
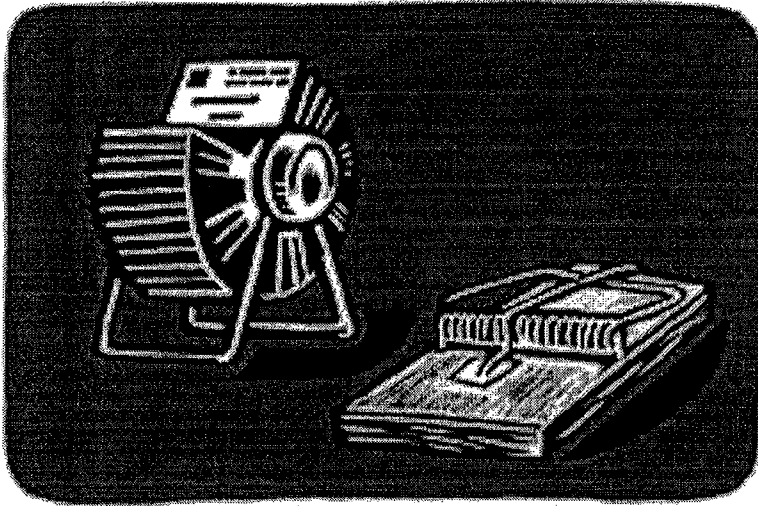
The present-value calculation of an investment-advisory business consists of two key components, says Darrell D. Dorrell, a business-valuation expert and principal of Financial Forensics in Lake Oswego, Ore. The first is the future economic benefit stream, such as net income and cash flow; the second is the firm's capitalization rate. According to

Dorrell, the absence of a nonsolicitation agreement affects the capitalization rate in a negative way.

To illustrate that impact, consider a business generating \$1 million in annual revenue. A common capitalization rate for a closely held business in the financial-services industry is 25 percent, says Dorrell. Therefore, the valuation of the company is determined by dividing the annual revenue, or \$1 million, by the capitalization rate of 25 percent. The value of the business, therefore, is \$4 million before secondary adjustments such as lack of marketability.

Without a nonsolicitation agreement, the capitalization rate would be as much as 5 to 10 percent higher, says Dorrell. "Such increase would be based on the additional risk premium related to a key-person discount," he explains. Therefore, lacking a nonsolicitation agreement, the same company would be valued at roughly \$2,857,000, or \$1 million divided by 35 percent, before secondary adjustments. That is to say, the company's lack of nonsolicitation agreements could cost principals \$1,143,000, or 29 percent of the value of the firm.

—ERD



Other states will enforce an agreement signed by an existing employee only if she got some other consideration, such as a promotion, bonus, or raise at the time of signing.

An agreement signed under duress is also problematic. For example, if an employee is not told about the agreement until he has already quit his previous job and shows up for his first day of work, then he may be able to persuade a court to deem it unenforceable, says Sutton. To avoid this, Sutton suggests discussing the nonsolicitation agreement with all prospective employees as early as their initial interview and providing them with a copy of the agreement along with the letter offering them employment. The agreement should be signed by the employee prior to starting employment.

If your firm doesn't already have agreements in place, one way to enforce them with existing employees may be to include nonsolicitation clauses in non-ERISA benefit arrangements, such as deferred-compensation plans or severance arrangements. A deferred-comp plan might stipulate, Sutton suggests, that the employee will be paid a certain

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too long. How long is too long? That depends on the state, the firm, and the particular employee, says Agins, but most courts are likely to find that a one-year prohibition is fine and a five-year ban is excessive.

There are also differences among the various states as to what constitutes adequate consideration for the employee. For example, Giachetti says, the promise of continued employment is not viewed as adequate consideration to the employee in New Jersey and California. In other words, an employer in those states will be unable to enforce an agreement signed by an employee after she has already started working at the firm. The same is true in Oregon, which specifically requires that nonsolicitation agreements be signed prior to the first day of employment, says Sutton.

amount on the condition that she doesn't solicit firm clients after she leaves—and if she does, she'll have to pay back any amounts already received. But again, if such language is simply tacked on to existing benefit agreements, some courts may rule that they are not supported by adequate consideration to the employee.

Even the most carefully crafted agreement could be deemed unenforceable if a court decides one or more terms are unreasonable. To prevent that from happening, Giachetti recommends that every agreement include language allowing a court to revise any provisions it deems unreasonable. For example, if an agreement provides that a former employee cannot solicit clients for three years, and the court finds that length of time unreasonable, the court

could revise the term to a period it deems reasonable.

Advisers who want to avoid dragging former staffers or clients into court could consider including an arbitration clause in their nonsolicitation agreements, whereby both parties agree to settle any disagreements out of court—and as a result save time and money. But neither Giachetti nor Sutton likes that option. If former employees violate an agreement, it's critical that the adviser be able to go to court immediately to get a temporary injunction, says Sutton. In fact, he adds, if an employee leaves and you even suspect he's going to solicit clients, you want to be able to get a preliminary injunction before he takes any action. This would be impossible if arbitration is built in to the process.

Whether or not you ever go to court to enforce nonsolicitation agreements, having employees sign them can be a powerful deterrent. "If you have something in writing, it puts the fear of God in people," says Agins. "They'll think, 'They're going to come after me.'" To enhance this effect, Giachetti recommends sending letters to

Agins at one time represented two advisers who just before Christmas left a firm where they had signed nonsolicitation agreements and headed home for the holidays with no plans to compete with their former firm. But several of their clients tracked them down after the New Year and asked the advisers to continue working with them. They agreed, and their former employer sued them. The ex-employees had taken no files, made no calls, and taken no other actions to violate the nonsolicitation agreements. After several years of litigation, the former employer couldn't prove the ex-employees had solicited clients, and legal fees had gotten too expensive to justify continuing the lawsuit. In the end, both sides signed releases and moved on.

Another problem with filing a lawsuit: To prove that ex-employees solicited customers, you may have to call clients as witnesses. "As a general rule, customers don't appreciate that you dragged them into court and don't like the idea that you 'own' them," Sutton says. Even if you end up proving your case, he adds, you're unlikely to get the customer back.

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former employees as soon as they leave the firm reminding them of the agreement and stating that you trust they're not going to violate it. Sutton suggests including language in the original agreement that requires employees to disclose it to any new employer. "It puts new employers at risk of being sued if they knowingly agree to let the employee breach the agreement to their own benefit," he says.

Deterrence is important because enforcing nonsolicitation agreements through litigation can be problematic and expensive. "They generally work better when employees abide by them rather than if you have to enforce them," Sutton says.

What constitutes solicitation? Plain-vanilla nonsolicitation agreements specifically prohibit ex-employees from actively pursuing clients. So if a former staffer merely calls clients to inform them that he's leaving your firm, he has not engaged in solicitation. Telling clients where he is going, however, could be construed as solicitation, Sutton says. But if employees leave and clients track them down, or if ex-employees advertise in trade publications and clients respond, solicitation hasn't taken place, Agins says.

To avoid having to prove former staffers solicited clients, Giachetti recommends that agreements also prohibit the rendering of services, which is much easier to prove.

Some clients may simply be determined to leave with former employees. One way to soften the blow in those cases, Giachetti says, is to include provisions in your agreement requiring former employees to pay specified damages, known as liquidated damages—say, one to two times the past year's revenue—for any clients they leave with. But including such a provision will likely dilute the deterrent effect of your agreement, Sutton says, because some employees may justify paying the damages as a cost of doing business.

In the end, an adviser should never shy away from litigating, say the experts. If a former staffer walks out the door and takes customers with her, then other employees will feel emboldened to follow suit. "Sometimes you have to enforce agreements to set an example," Sutton says.

Elayne Robertson Demby, JD, covers executive compensation, employee benefits, and financial issues.