An Update on the Enforcement of Non-Compete and Non–Solicitation Clauses

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The Protocol for Broker-Dealer Recruiting - Background

Created in March 2005 by Citigroup Global Markets (Smith Barney), Merrill Lynch, Pierce Fenner & Smith, Inc., and UBS Financial Services, Inc.

Designed to address issues that arise when registered representatives transition between broker-dealers and further the clients' interest of privacy and freedom of choice in connection with the movement of their Registered Representatives ("RRs") between firms.

More than 1,450 broker-dealers have signed the Protocol.

The Protocol for Broker-Dealer Recruiting - Background

Applies to RRs transitioning between signatory firms so long as they comply with spirit and terms of the Protocol.

Neither the departing RR nor the firm that he or she joins would have any monetary or other liability to the firm that the RR left by reason of the RR taking the information identified below or the solicitation of the clients serviced by the RR at his or her prior firm.

Signatories effectively give up their rights regarding non-solicitation of clients against financial advisors that depart their firm for another signatory firm.

The Protocol does not, however, bar or otherwise affect the ability of the prior firm to bring an action against the new firm for "raiding."

The Protocol for Broker-Dealer Recruiting - Background

In order to invoke the protections provided by the Protocol, a departing RR must deliver a ***written resignation*** to the manager at the departing Broker Dealer and shall include a list of information that the RR will be taking with him or her. A departing RR may only retain the following "Client Information":

- Client Names;
- Client Addresses;
- Client Phone Numbers;
- Client Email Addresses; and
- Account titles.

The Protocol for Broker-Dealer Recruiting - Background

In order to invoke the protections by the Protocol, a departing RR must also observe the following requirements under the Protocol:

- RR must not solicit or recruit other representatives or employees of the departing firm to leave, or otherwise engage in "raiding" activities;
- RR must not solicit or inform clients of his or her intended departure **before** submitting a written resignation;
- RR must not take any information other than Client Information;
- RR must compile Client Information in good faith and leave copy with the departing firm (attached to resignation letter);
- RR must limit the use of Client Information to solicitation of clients to the new firm;
- RR must not allow any other representative, independent contractor, or employee of the new firm use the Client Information for any purpose; and
- RR must refrain from using the Client Information until the broker is affiliated with his or her new firm.

The Protocol for Broker-Dealer Recruiting - Background

If the departing RR is a part of a team of representatives and the entire team is not transitioning to a new firm, the team or partnership agreement controls whether the Client Information may be taken to the new firm.

Absent such an agreement, the departing team member may take Client Information for all clients serviced by the team, so long as the representative was a member of that team for four years or more.

If the departing team member was a team member for less than four years, he or she may only take Client Information for those clients that he or she introduced to the firm/team.

Jurisdictional Issues

Even if the parties agree the subject matter is subject to FINRA arbitration, the expectation of speedy arbitration does not absolve the district court of its responsibility to decide requests for preliminary injunctions on their merits. *Am. Exp. Fin. Advisors Inc. v. Thorley*, 147 F.3d 229, 231 (2d Cir. 1998).

Non-FINRA members are not compelled to arbitrate their claims even if their claims are inextricably intertwined with a FINRA's member's. *See Hantz Group v. Van Duyn*, 2011 Mich. App. LEXIS 1212 (Ct. App. Mich. 2011); *Bank of Am., N.A. v. UMB Fin. Servs.*, 618 F.3d 906 (8th Cir. 2010).

Considerations:

- What entities would be included in any dispute? Is the rep a part of insurance, accounting, banking, consulting, or other non-securities entities that would be involved in any dispute over non-compete/non-solicitation agreements? Are any of the other involved-entities non-FINRA members?
- Do any of the agreements with the non-FINRA members contain arbitration provisions? If so, FINRA or AAA or another forum.
- Would you be litigating the case in different forums? How would this impact defense costs and your potential exposure?
- Federal court vs. state court?

Recent Case Law Re: Bad Faith

- Representing the Rep: Will you lose your ability to rely on the Protocol if your client does not strictly comply?
- Representing the Receiving BD: Will your RR be exposed to liability (and will you potential be exposed due to his/her actions occurring as your rep) if he/she does not strictly comply?
- Representing the Former BD: Can you use actions of non-compliance to avoid the protections of the Protocol and bring actions for breach of non-solicitation agreements/violation of trade secret act/etc.?

Recent Case Law Re: Bad Faith

- *UBS Fin. Servs. v. Fiore*, 2017 U.S. Dist. LEXIS 115134 (D. Conn. July 24, 2017):

  Summary: UBS brought an action alleging breach of contract, misappropriation of trade secrets, breach of fiduciary duties and unfair competition after a team of RRs departed with a large book of business. Defendants worked as part of a financial advisor team while at UBS with $8 billion in assets under management and $6 million in annual gross revenue. All team members signed various non-solicitation and confidentiality agreements, prohibiting solicitation of UBS clients for one year after termination and prohibiting the use of any confidential information covered by the agreements. After UBS terminated one of the team members, he started his own firm ("Procyon") and the other team members resigned from UBS shortly thereafter and joined his firm. Each team member resigned and included a Protocol list of clients that had been services by the group. After joining Procyon, the group contacted the clients on the Protocol list. They also contacted a handful of clients not included on the Protocol list. Both UBS and Procyon were signatories to the Protocol.

  Arguments: UBS argued the Protocol did not apply because the group engaged in "bad faith conduct" because, (1) the team contacted clients who were not identified on the Protocol List and (2) engaged in intentional acts prior to leaving to alter files: "I sorted the private client list by Zipcode just to f**k with them a little. It's the small things…"

Recent Case Law Re: Bad Faith

Reasoning:

- The Court rejected UBS's argument and relied on the following language from the Protocol: "In the event that the [original] firm does not agree with the [departing financial advisor's] list of clients, the [financial advisor] will nonetheless be deemed in compliance with this protocol so long as the [financial advisor] exercised good faith in assembling the list and substantially complied with the requirement that only Client Information related to clients he or she serviced while at the firm be taken with him or her." To this end, the Protocol Defendants did not solicit any clients **before** their resignation, did not take more information that what was permitted under the Protocol, and put together the Protocol List based on what clients the group serviced, which appeared to be in good faith.
- The Court rejected UBS's argument that the group's solicitation of three institutional clients and one individual client not included on the Protocol List disqualified them from relying on the Protocol. The Court found that the group's sending of communication to these limited clients did not rise to the level of bad faith.
- **Ultimately, the court concluded that, while some of the Protocol Defendants' conduct may be deemed improper, it does not rise to the level of the type of "bad faith" Protocol violation that could remove the Protocol Defendants from the protections of the Protocol.**

Result: The Court denied UBS's motion for a preliminary injunction.

Recent Case Law Re: Bad Faith

- Courts have concluded that a RR engaged in "bad faith," in which case any non-solicitation agreement will apply and courts are free to find trade secrets violations.
  - A departing RR altered clients' contact information in his employer's database before tendering his resignation letter in compliance with the Protocol was found to have violated the Protocol by acting in bad faith. *Morgan Stanley Smith Barney LLC v. O'Brien*, 2013 U.S. Dist. LEXIS 159128, *4-5 (D.C. Conn. 2013).
  - Where a departing RR removed physical client files, operational documents, deleted his contact list from his former firm prior to his resignation, and removed a large client from his client list, the court found the RR acted in "bad faith" and declined to apply the Protocol. *Morgan Stanley v. Choy*, No. Civ. 08-00467, 2009 U.S. Dist. LEXIS 10539 (D. Haw. Oct. 29, 2008).

Recent Case Law re: Announcement v. Solicitation

Is a letter to clients going to be perceived as an “announcement” or a “solicitation”?

As the Broker-Dealer, your compliance department/counsel may be asked to approve this type of letter when the RR joins your firm.

Understand your potential exposure.

Recent Case Law re: Announcement v. Solicitation

UBS Fin. Servs. v. Fiore, 2017 U.S. Dist. LEXIS 115134 (D. Conn. July 24, 2017):

- A defendant breaches their non-solicitation agreement when sending an announcement that announces their new firm ***and*** their particular expertise to a targeted recipient list that includes clients from their former firm.

Marsh USA Inc. v. Schurhriemen, 183 F.Supp. 3d 529, 536 (S.D.N.Y. 2016), amended 183 F. Supp. 3d 529, 2016 WL 2731588 (S.D.N.Y. 2016).

- An email to clients and others announcing that he had joined a new firm and indicating his expertise servicing clients in the healthcare industry was considered an improper solicitation.

Recent Case Law re: Announcement v. Solicitation

1. A neutral announcement of an FA's new employer and contact information to the former clients (and who are listed on the Protocol list), however, would be permissible and reasonable so long as it does not encourage clients to leave UBS or tout the FA's new employer. *UBS Fin. Servs. v. Christenson*, 2013 U.S. Dist. LEXIS 69067, *14 (D.C. Minn. 2013).

2. "While we do not question the rights of parties to make public announcements of changes in employment, 'targeted mailings' to former customers may cross the line into impermissible solicitation." *Corporate Techs., Inc. v. Harnett*, 731 F.3d 6, *12 (1st Cir. 2013).

3. If such an announcement actually asks former firm clients to continue to do business with the defendant at his or her firm, it will be a solicitation. *Morgan Stanley Smith Barney LLC v. O'Brien*, 2013 U.S. Dist. 159128, *3-5 (D. Conn. Nov. 6, 2013)

Announcement v. Solicitation through Social Media

Arthur J. Gallagher & Co. v. Anthony, 2016 U.S. Dist. LEXIS 116384 (Aug. 30, 2016) – press release posted on LinkedIn and Twitter by employee's new employer did not violate agreement because not posted on employee's own social media.

Bankers Life and Casualty Company v. American Senior Benefits, 2017 IL App (1st) 160687 (Ill. Ct. App. Aug. 7, 2017) – requesting connections via LinkedIn does not by itself establish violation of non-solicitation merely because connection allows people to view content.

Announcement v. Solicitation

- Include non-clients (family, friends, non-clients in the community).
- Don't tout expertise of the Rep or new firm.
- Don't ask for the client's continued business or encourage clients to leave the old firm.
- Don't ask for the client to contact you or the new firm.
- Keep social media announcements general, and when possible, have the announcement come from the firm.

Recent Case Law re: Client Information

Who owns the client information/list?

Is the information owned by a Protocol firm (or owned by an affiliate, non-Protocol firm)?

Are there agreements in place between the Protocol firm and other non-Protocol firm dictating who owns the information?

What about dually registered representatives?

Recent Case Law re: Client Information

Keating v. Jastremski, 2016 U.S. Dist. LEXIS 130816 (S.D. Cal. Sept. 23, 2016)

- Plaintiff was The Retirement Group ("TRG") and brought claims against departing independent advisor representatives ("Advisors").
- TRG was a registered investment advisor with the SEC but not a broker dealer and not a signatory to Protocol.
- TRG contracted with the Advisors in their capacity as Independent Advisor Representatives to provide services for its clients.
- TRG used a proprietary system of client information that it considered to be confidential, trade secrets and offered clients broker-dealer specific products through FAS Securities Corporation, a FINRA broker-dealer, and a signatory to the Protocol.
- The Advisors were registered representatives of FAS, but had separate confidentiality/trade secret agreements with TRG. After the Advisors terminated their affiliation with TRG, they attempted to rely on the Protocol to take Client Information maintained by FAS about TRG's business to another Protocol firm, Securities America, Inc. TRG claimed the taking of the Client Information was improper and claimed the Advisors could not rely on the Protocol because (1) TRG was not a signatory and (2) the information taken was not owned by FAS.

Recent Case Law re: Client Information

- Reasoning: The Court reasoned that the TRG information was (1) owned by FAS, (2) created by and used for the benefit of TRG, and (3) on FAS's system pursuant to strict confidentially agreements and other protections (e.g., assess codes, security clearance, etc.). As a result, the Advisors could not rely on the Protocol in taking the Client Information as an absolute defense to the claims brought by TRG.

- Holding: The court denied summary judgment, finding there were enough disputed facts to create triable issue as to trade secret claim.

Major Take-Aways

- Improve your on-boarding process. Understand all agreements and relationships.
- Document.
- Does the Protocol apply? Are there any exceptions, limitations, or other amendments to the Protocol?
- Who owns the Client Information?
- Take only the 5 categories of permitted information and comply with written resignation requirement.
- Avoid soliciting of former co-workers.
- Do not alter/destroy documents/information—avoid "bad faith" exception.
- Announcement vs. solicitation? Send AFTER submitting the resignation and leaving the firm.
- Social media.
- Coverage?

DTSA…. So You Say?

18 U.S.C. §1836 – Defense of Trade Secrets Act

- Signed by President Obama on May 11, 2016.
- Provides a federal private right of action for misappropriation of "Trade Secrets."
- Does ***NOT*** preempt state law cause of action for misappropriation of "Trade Secrets."
- Employer size and dollar value of Trade Secret is irrelevant.
- More money more problems.
    - DTSA remedies + UTSA remedies = more trade secret remedies = more trade secret litigation.
- In the two states that have not adopted some version of the UTSA (New York and Massachusetts), DTSA changes the law.
- DTSA grants whistleblower immunity

What is a ‘Trade Secret’

- Defined broadly, the term "trade secret" means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if--

  (A) the owner thereof has taken reasonable measures to keep such information secret; and

  (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.

‘Customer lists’ can be ‘trade secrets’

Notable 2016 DTSA Decisions

First written DTSA decision illustrating interplay between DTSA and state law

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Henry Schein, Inc. v. Cook, 2016 U.S. Dist. LEXIS 76038 and 2016 US Dist. LEXIS 3212457 (N.D. Cal. June 10 and 22 2016)

- Former sales rep joined competitor
  - Emailed herself large amounts of data before resigning
  - Kept trying to delete data and scrub company laptop for 2 weeks after resigning
  - Accessed HIS data from an iPad after *resigning*
- HIS sued in federal court alleging 8 counts including misappropriation under DTSA
- Court granted *ex parte* TRO and then preliminary injunction under the DTSA, restraining Cook from accessing using or disclosing "confidential proprietary or trade secret documents, data or information"
- Court found
  - Customer histories were protectable as a trade secret
  - Cook took material using "improper means"
- BUT, Court did not enjoin solicitation of customers based on California prohibition on non-solicit

Notable 2016 DTSA Decisions (cont.)

Decision interpreting DTSA's statute of limitations

Adams Arms LLC v. Unified Weapons Sys., 2016 U.S. Dist. LEXIS 132201 (M.D. Fla. Sept 27, 2016)

- UWS entered into a solo contract with foreign government to manufacture rifles using AA's technology
- AA sued in federal court alleging 8 counts, including misappropriation under DTSA
- UWS moved for dismissal relying on statute-of-limitations arguing that:
  - The DTSA did not become effective until May 11, 2016, after the events at issue
  - AA's claims should be treated as a "continuing misappropriation" or a single misappropriation

- Court said that the limitations addresses only when the claim accrues, it does not address whether an owner may recover under the DTSA when the misappropriation occurs before *and* after effective date.
- Instead, the Court looked to Section 2(E), which specifies that the DTSA applied to:
  - "any misappropriation… for which ***any*** act occurs after the effective date."

- Court held that AA sufficiently stated a claim for disclosure of trade secrets after May 11, 2016, BUT dismissed the claim to the extent it was based on UWS's acquisition of the trade secrets ***prior to*** May 11, 2016

Other Notable 2016 Decisions

Big verdicts against bad leavers

Epic Sys. Corp. v. Tata Consulting Servs. Ltd. Case No. 14-cv-00748-wmc (W.D. Wisc. Apr. 15, 2016)

- $940 million jury verdict for misappropriation of trade secret, breach of contract, unfair competition, and unjust enrichment
  - $240 million compensatory; and
  - **$700 million** in punitive damages
- Adverse inference from discovery abuses drove verdict
- Motion for judgment as a matter of law pending
  - Punitives likely to be reduced to $480 million due to Wisconsin statutory cap (double amount of compensatory)

Damages Considerations

- Understand the theory of damages.
  - Is the RR coming from an IBD?
  - Does the RR generate revenue for the prior firm for non-securities work (e.g., accounting, planning, insurance, consulting, etc.) that may be included in the lost profits calculation. Understand this potential exposure.
  - What is the former firm's compensation model?
  - What is their pay-out to the RR vs. amount kept by the firm?
  - Understand any overhead, expenses, benefits, taxes, and other categories that would reduce the profit generated from the RR.

- Understand Trade Secrets Act Claim/DTSA
  - Potential for 2X or 3X damages under some Acts.
  - Potential for recovery of punitive damages (if willful or malicious conduct)
  - Potential recovery of reasonable attorney's fees to prevailing party.

Questions?

Thank you!