



Protecting the Value of an Investment Advisory Firm

The Transformation to a Sustainable Business

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One of the most popular topics among industry gurus is how independent practitioners of financial planning and asset management can transform their personal practices into sustainable investment advisory businesses that eventually may be sold to third parties. Unfortunately, these discussions often fail to address how a practitioner/owner should protect his or her firm's most important asset—its client relationships—during such a transformation.

Often the most significant competitive threat facing a practitioner/owner of an investment advisory firm isn't a larger, better-resourced firm in the community or market niche. The more likely and more dangerous competitive challenge may come from within the practitioner/owner's own firm. Those very employees hired by the practitioner/owner in an effort to create a sustainable business often are making their own plans to establish competing firms with their current firm's clients.

In light of this possibility and the relatively small amount of capital necessary to start a new investment advisory firm, a practitioner/owner must utilize legally enforceable contractual restrictions that properly protect the firm's interest in its client relationships from departing employees.

Restrictive Employee Covenants

Restrictive employment covenants between the firm and the employee typically cover the following areas:

1. The confidential treatment of client information and agreement by the employee to refrain from unauthorized disclosures or the use of such client information during and after the employee's employment with the investment advisory firm.
2. Prohibition of the employee from soliciting certain clients and fellow employees during and after his or her affiliation with the firm.

Although these covenants may sound simple, traps abound. As a matter of public policy, most state courts will not enforce restrictive employment covenants unless an employer can show a protectable interest and that the restrictions have been narrowly tailored to meet this protectable interest.

The following are a few examples of issues that a state court may consider when determining whether to enforce restrictive employment covenants:

1. What is the employer's protectable interest supporting the use of a restrictive employment covenant? Most states will find that an employer has a protectable interest in the retention of existing clients and the protection of trade secrets and confidential information. For example, a court may find that an employee working with existing clients and access to

certain information would have an unfair business advantage in future competition with the employer. However, a court may find that an employer does not have a protectable interest with respect to nonsolicit provisions that prohibit an employee from working with an employer's past or future (not current) clients.

2. Did the employer actually provide adequate consideration to the employee for agreeing to the restrictive covenants? In certain states, if an employer requires an existing employee to sign restrictive covenants as a condition of continued employment in the same position, the courts may find this as inadequate consideration to support a restrictive covenant.
3. Is the time restriction of the nonsolicit prohibition reasonable? Although this is a fact-specific question and differs significantly among states, many courts have found nonsolicit time restrictions beyond two years are unreasonable.

It is critical to recognize that in some states the courts will not sever (selectively strike) those overly broad portions of restrictive employment covenants; therefore they will refuse to enforce an agreement that is not fully in compliance with the law. This often is referred to as the "all or nothing" rule, which means the court will not modify or otherwise enforce any set of restrictive employment

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covenants if there is any provision that is beyond what is permitted by the law. In other words, an overly aggressive set of restrictive employment covenants can result in absolutely no protection to an employer in certain states.

In light of this ambiguity, the significant differences between the states in this area of law, and the serious consequences associated

with these disputes, a practitioner/owner should employ an attorney who is skilled in this area to prepare documents that can reasonably withstand the challenge of a departing employee. Without the restrictive employment covenants, a practitioner/owner is vulnerable to losing much of the value associated with his or her investment advisory firm. **M**

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