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Trade Secrets

Real Estate Private Equity Adviser Sues Former Executives Alleging Theft of Trade Secrets

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By Alessia Bell, *Hedge Fund Law Report*

On July 13, 2012, San Francisco-based real estate private equity adviser Liquid Realty Advisors, LLC, along with investment funds managed by Liquid, and Liquid's owner Scott Landress (collectively Liquid or Plaintiffs), sued Clairvue Realty Advisors, LLC and related entities (Clairvue or Defendants). Liquid alleges that three of its former executives who left to form a competing business in partnership with Goldman Sachs Asset Management (GSAM) mismanaged the execution of several investments, incurring a loss of over $100 million while at Liquid, and unlawfully took confidential information and proprietary business tools from Liquid to Clairvue.

Like private equity advisers, hedge fund managers have increasingly faced the need to zealously guard their trade secrets in an era where technology is both fundamental to proprietary trading strategies and can abet the theft of them. See, e.g., "Eight Measures That Hedge Fund Managers Can Take to Mitigate the Risk of Theft of Their Trade Secrets," Hedge Fund Law Report, Vol. 5, No. 21 (May 24, 2012). Liquid's action in this case is part of a flurry of recent high profile suits designed to redress – and in some cases criminalize – the theft and misuse of confidential information and proprietary trading strategies. See "Protecting Hedge Fund Trade Secrets: What a Difference a Year Makes," Hedge Fund Law Report, Vol. 5, No. 16 (Apr. 19, 2012).

This article summarizes the factual allegations in Liquid's complaint (Complaint) as well as the causes of action and relief requested.

Overview

Scott Landress was the Chief Executive Officer (CEO) and Managing Partner of Liquid. Founded in 2001, Liquid (according to its own Complaint) was a pioneer and global leader in the multi-billion dollar real estate private equity secondaries investment market. Liquid spent millions of dollars developing proprietary tools for running its business.

Clairvue's founders, Jeffery Giller and Joshua Cleveland, began to work at Liquid in mid-2005, and Brendan MacDonald joined Liquid in 2007 (collectively, the Clairvue Founders). Due to arbitration agreements with Liquid, the Clairvue Founders are not named defendants in the Complaint but instead are named as "John Does" at this stage in litigation. The Clairvue Founders were principals and high-level officers of Liquid Realty Advisors, LLC and, per the terms of their employment agreements and under California law, had contractual and fiduciary duties that included confidentiality, non-competition, non-solicitation and a duty to bring all

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investment opportunities to Liquid. See "Arbitration Award in Connection with an Unceremonious Departure from Oaktree Capital Management Precludes Legal Malpractice Claim Against Attorney Retained to Advise on Departure," Hedge Fund Law Report, Vol. 4, No. 28 (Aug. 19, 2011).

The Complaint alleges that the Clairvue Founders' "grossly deficient" performance at Liquid cost the firm $100 million in lost investments and additional millions of dollars in "dead deal" costs.

The Clairvue Founders left their positions at Liquid in the fall of 2009, allegedly blaming Landress for their decision to resign. Shortly after their departures, they formed San Francisco-based Clairvue Capital Partners, Clairvue Realty Advisors, LLC (Clairvue Realty) and a first fund called Clairvue Capital Partners I. GSAM's Private Equity Group, whom the Clairvue Founders had met while working at Liquid, provided an initial $250 million capital commitment as a partner in Clairvue Capital Partners I and invested additional millions in Clairvue Realty. Clairvue Realty is owned directly by the Clairvue Founders in partnership with GSAM. Clairvue Capital is owned by its principals with investment funds managed by GSAM.

The Complaint alleges that the Clairvue Founders lied about their achievements at Liquid and stole the company's trade secrets, proprietary data, and investment opportunities. Allegedly ruined by the Clairvue Founders' unlawful actions, Liquid is now winding down its business.

Liquid's Confidential Information and Proprietary Investment Tools

The private equity secondaries market provides liquidity to private equity investments, which are generally long-term and illiquid. In certain secondaries transactions, known as "investor secondaries," investors buy and sell pre-existing interests in private equity funds and assume unfunded investor commitments. By contrast, in "sponsor secondaries" or "recapitalizations," investors directly provide capital to private equity funds or partnerships.

According to the Complaint, before 2001, there was an active secondaries market for buyout, venture capital and other private equity investments, but real estate private equity secondaries were almost non-existent. The Complaint claims that Landress was a pioneer in raising funds for and doing business in real estate private equity secondaries, and Liquid soon became known as "the global leader" in this market.

According to the Complaint, Liquid's success rested on extensive amounts of proprietary information and unique business tools that took years to develop, at a cost of millions of dollars. The proprietary information and technology included Liquid's:

- Annotated Contact database, which included detailed information on nearly 22,000 contacts; it was a "gold mine to someone who is looking for investment capital, deal leads and service providers in the sparsely populated real estate secondaries field."
- Equity Book, a consolidated list of thousands of institutional real estate investors.
- Pipeline Reports, a running weekly log of real estate secondary investment opportunities and clients, including information on exactly where to find recapitalization and other deals.
- Underwriting Models, the "secret" of Liquid's success, which were detailed (30-plus page) templates on how to identify, evaluate and close real estate secondaries deals.
- "Hokey Pokey" Portfolio Analysis Technology, which allowed analysis of complex real estate secondaries portfolios with easy substitution of funds in and out of portfolios to determine

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which portion of an investment Liquid wanted to keep in a deal.

- Investment Committee Memoranda, which contained information on investment underwriting, pricing and returns.
- Archived Data Resources, which included gigabytes and file drawers of data on a total of nearly 1,500 relationships and opportunities in the real estate secondaries market.

Duties of Confidentiality and Non-Competition

Giller was hired in mid-2005 to be Liquid Realty's Managing Principal and Chief Investment Officer. Second in seniority after Landress, Giller's primary responsibility was to originate and make real estate secondary investments and to sell certain investments shared by Liquid's second and third funds. When he joined Liquid, Giller signed a "Memorandum of Understanding" stating that the parties intended that he would become an equity owner of Liquid Realty and any future funds, but reserved for the company ultimate discretion over whether to grant him a partnership interest.

Joining after Liquid's first fund closed, Giller was made a "key man" in Liquid's second, third, fourth, fifth and sixth funds. This "key man" status allowed limited partner investors in these funds to withdraw if Giller left Liquid by vetoing a replacement employee.

Cleveland was hired in mid-2005 to be Liquid's Director of Business Development, responsible for identifying real estate secondaries. MacDonald was hired in 2007 as Associate (and later Director) of Acquisition, to assist Cleveland and Giller. Andrew Jensen (not a Clairvue Founder) was hired in early 2005 as a finance and accounting manager; he later became Chief Financial Officer. According to the Complaint, the Clairvue Founders had no experience in the real estate secondaries market before joining Liquid.

The Clairvue Founders and Jensen signed an Employment Agreement, an Arbitration Agreement and a "Non-Disclosure, Non-Compete and Work-For-Hire Agreement," which had confidentiality, non-disclosure and non-competition provisions and made all of Clairvue Founders' and Jensen's work product the property of Liquid. The "Non-Disclosure" agreement broadly defined confidential information to include, inter alia, information on Liquid's investments, partners, investors, databases of potential sellers and investors, computer models, databases of fund performance and business methods. The agreement further provided that confidential information be kept in the strictest confidence during and after the employee's tenure with Liquid. Additionally, the agreement provided that all material used during the course of employment, including memoranda, files, databases, etc., was the property of Liquid and was to be delivered to the company upon termination of employment. See "Schulte Roth & Zabel Partners Discuss Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements," Hedge Fund Law Report, Vol. 4, No. 42 (Nov. 23, 2011).

Per the terms of the "Non-Disclosure, Non-Compete and Work-For-Hire Agreement," the Clairvue Founders and Jensen had contractual obligations not to compete with Liquid or interfere in any manner with Liquid's business or solicit business opportunities (except on Liquid's behalf) during the course of their employment and for 18 months thereafter. The agreement specifically barred the Clairvue Founders and Jensen from "compet[ing] with the Company in . . . its business of acquiring on a secondary basis interests in private real estate funds, partnerships, or other illiquid vehicles" and from "work[ing] for on behalf of another company or entity . . . that, as all or a meaningful part of their business, will be seeking, on a

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'secondary' basis, to purchase private real estate fund or limited partnership interests or other private securities." Additionally, the Clairvue Founders and Jensen agreed to reimburse Liquid for all costs connected with any breach of the non-compete agreement.

Note that in some instances courts have deemed non-disclosure and non-competition agreements overly restrictive and have refused to enforce these agreements. See "District Court Decision Suggests That Overly Broad Restrictive Covenants Will Not Be Enforced in Employment Agreements in the Wealth Management Industry," Hedge Fund Law Report, Vol. 5, No. 17 (Apr. 26, 2012).

Clairvue Founders Perform Poorly and Leave Liquid

According to the Complaint, the Clairvue Founders performed poorly at Liquid. Giller made his first investment a year and a half after he was hired and lost $22 million (28% of the investment), the second-largest loss in Liquid's history. Cleveland made his first and only investment two years after he was hired and lost $17 million (84% of the investment), the worst loss of all Liquid investments in percentage terms. Five combined investments that Cleveland and Giller made in 2007 lost $41 million (40% of these investments). MacDonald made his first and only investment in Liquid a year and a half after he was hired and lost $2.5 million (30% of the investment). Giller made an investment on behalf of Liquid's third fund that lost $44 million (76% of the investment), the largest realized in Liquid's history.

Altogether, the Clairvue Founders were responsible for making $203 million in investments for Liquid, which represent 16% of Liquid's total investments, 5% of its distributions and 80% of its current uncalled capital. They also were responsible for nearly 100% of Liquid's broken deal costs. Nine of the eleven investments made by Clairvue Founders are losing money, reporting a loss of $55 million (27%) to date. Together with the investments made on Liquid's behalf, the Clairvue Founders lost approximately $100 million for Liquid to date.

In early 2008, Jensen resigned from Liquid allegedly because he did not get a bigger stake in the company. Following complaints about their unsatisfactory performance, the Clairvue Founders threatened to leave in mid-2008, saying they had found a "large balance sheet" investor to start their own firm to compete with Liquid. The Clairvue Founders agreed to stay, however, provided that either: (1) they could agree to mutually satisfactory partnership terms with Liquid, or (2) they and Landress would share 25% in each other's companies going forward.

Six months later, in mid-2009, the Clairvue Founders left Liquid. Landress believed that they were leaving Liquid to set up their own investment firm with the help of a "big balance sheet" backer and wanted to disclose as much to investors. The Clairvue Founders, however, denied plans to set up a competing business and stated they were leaving "for personal reasons to pursue other opportunities."

According to the Complaint, the Clairvue Founders' refusal to acknowledge that they were leaving as a group to set up a competing business was a death blow to Liquid, given that the financial market had hit bottom, no one was hiring and Liquid was still seen as a success. The Complaint further alleges that Clairvue Founders' "false statements left investors to think that there were deep problems at Liquid if they were leaving together but did not have another identifiable business opportunity. . . . Liquid's investors were led to believe that the Clairvue Founders were leaving because Liquid was in disarray and not to be trusted or relied upon."

Additionally, the Complaint alleges that shortly before leaving Liquid, in an effort to boost their new competing business, the Clairvue Founders attempted to further sabotage Liquid by their

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handling of Project Bertha, Liquid's most important investment. Begun in 2008, Project Bertha promised to offset the losses incurred by the Clairvue Founders, and, by raising a fourth fund, eliminate the risk that Giller's departure would be deemed a key man event by investors. See "Key Person Provisions in Hedge Fund Documents: Structure, Consequences and Demand from Institutional Investors," Hedge Fund Law Report, Vol. 2, No. 37 (Sep. 17, 2009). Given the make-or-break nature of the investment, Landress had directed Giller – who was far more experienced and successful than Cleveland – to focus his efforts solely on Project Bertha. Instead of doing so, Giller focused on his new venture and delegated responsibility for Project Bertha to Cleveland. Cleveland failed to complete the deal, resulting in substantial dead deal costs and irrevocable damage to Liquid's reputation.

Clairvue Founders Form Competing Business with Goldman Sachs

Landress generally barred Liquid employees from soliciting Goldman Sachs (including related entity GSAM) for investments because he viewed Goldman Sachs as a competitor to which he did not wish to give insights into Liquid's unique business. However, due to the importance of Project Bertha, Landress allowed the Clairvue Founders to approach Goldman Sachs about investing in the deal, but told them to "proceed with caution" and not to reveal any of Liquid's proprietary information. Contravening Landress' instructions, the Clairvue Founders gave presentations to Goldman Sachs (and ultimately to GSAM) that disclosed confidential marketing materials and described Liquid's business in detail.

Six months after leaving Liquid, Giller and McDonald announced that they were forming Clairvue Capital Partners, and held an initial closing of their first fund, Clairvue Capital Partners I, with a $250 million capital commitment from GSAM. Jensen joined Clairvue soon after. Ostensibly, Cleveland did not join Clairvue until 2011, immediately after his non-compete agreement with Liquid expired. The Complaint alleges that the timing of his official departure from Liquid was a ruse designed to protect New York-based Cleveland from liability for violation of his non-competition agreement. According to the Complaint, Cleveland in fact began working for Clairvue long before 2011.

The Complaint claims that "[e]verything about Clairvue mimicked Liquid – the strategy, the marketing, the clients, the company structure, the type and structure of investments and even the fund names. . . . Millions of dollars of Liquid's propriety work were all misappropriated to benefit the Clairvue Founders and their new Clairvue entities." The Clairvue Founders tried to distinguish themselves by claiming that Clairvue, in contrast to Liquid, focuses on recapitalizations, but according to Liquid, this is false because: (1) 15% of Liquid's business was recapitalizations, including deals the Clairvue Founders worked on while at Liquid; and (2) a substantial portion of Clairvue's business is in investor secondaries.

The Clairvue Founders currently promote their new venture by highlighting their success at Liquid, which, according to Plaintiffs, grossly mischaracterizes their actual poor performance at Liquid. See "Portability and Protection of Hedge Fund Investment Track Records," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011). Further, the Clairvue Founders claim to have a "vast network of industry relationships," a "granular due diligence approach [and] high level of experience in efficiently valuing secondaries," and an "edge" in underwriting – all of which allegedly result from the theft of Liquid's trade secrets and proprietary information.

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According to the Complaint, Clairvue has already closed several successful investment opportunities that it directly stole from Liquid, including a $60 million credit facility with Normandy Real Estate Fund, LP and a $20 million recapitalization of 8,500 multifamily affordable housing units with Castle Hill Housing Partners. In total, at least half of the investments in Clairvue Capital Partners I were with Liquid's clients.

While Clairvue has continued to succeed by allegedly using Liquid's trade secrets, Liquid was forced by its investors to cease operating, return capital and forfeit fees. In early 2012, Liquid stopped trying to solicit capital and laid off all but one employee.

Relief Requested

Plaintiffs claim that Defendants: (1) misappropriated their trade secrets in violation of California's Uniform Trade Secrets Act; (2) engaged in unlawful, unfair and fraudulent business practices in violation of California's Business and Professional Code; (3) interfered with prospective economic advantage by stealing the Plaintiffs' potential clients; (4) converted for their own use Plaintiffs' property including trade secrets, thereby depriving Plaintiffs of the value of that property; (5) tortiously interfered with contract by encouraging Giller, Cleveland and MacDonald to breach their duties of confidentiality and non-competition in order to access trade secrets and directly compete with Plaintiffs. Plaintiffs allege that by virtue of their unlawful activities, Defendants were and continue to be unjustly enriched.

Plaintiffs request a jury trial and demand compensatory damages, restitution of all ill-gotten gains, a reasonable royalty on Defendants' revenue derived from the use of trade secrets, punitive damages, exemplary damages of twice the amount awarded for actual damages and attorneys' fees and costs. Further, Plaintiffs seek an injunction preventing Defendants from using Plaintiffs' confidential information and trade secrets. Plaintiffs request that Defendants return all originals and copies and destroy all electronic versions of trade secret and confidential information.

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