This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Compensation

Hedge Fund Incentive Compensation Not Subject to Wage Claim under New York Labor Law

Apr. 11, 2014
By Sean R. O'Brien and Sara A. Welch, *O'Brien LLP*

A recent decision by a New York court interpreting the State's Labor Law is of great significance to hedge fund managers doing business in the State. In that decision, *Beach and Vollero v. Touradji Capital Management, LP*, the Court dismissed claims brought by two portfolio managers under New York's Labor Law on the ground that the incentive compensation claimed by the employees did not constitute "wages" under the statute, and therefore could not support a claim. The ruling is important to hedge fund firms because it recognizes that incentive-based compensation to financial industry employees – which typically depends on the overall success of the business (or at least of a team of employees) and not on the performance of a single employee – is not the sort of compensation that merits protection under the Labor Law.

The Claims

In *Beach and Vollero*, two individuals worked for a hedge fund manager for over four years, during which time they were paid a salary. The employees claimed that at the outset of their employment they also were orally promised a share of the trading profits generated by a number of investment books that they, along with a portfolio manager and a number of analysts and other investment professionals, helped manage. The employees also claimed that they were entitled to earnings on amounts that they claimed had been deferred over their objection, with those earnings measured by the performance of the overall fund. While the managers did receive millions of dollars in bonuses during their time at the fund, they were not paid in accordance with the oral agreement that they alleged existed. Upon leaving the firm, the employees sued the firm for over $50 million in incentive compensation they claimed they were owed under the alleged oral agreement.

The Statute

New York's Labor Law imposes penalties on employers who fail to pay their employees' "wages," including mandatory liquidated damages in an amount equal to, and in addition to, the amount of any unpaid wages (absent a showing of good faith by the employer), attorneys' fees and prejudgment interest. In addition, the failure to pay wages when due can be a criminal misdemeanor under the Labor Law, both for the firm and its individual officers. Given the large

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
dollar amounts that are often involved in hedge fund compensation disputes and the potential for criminal penalties, it is extremely important that hedge fund employers have a clear understanding of what forms of compensation will or will not constitute "wages" under the Labor Law. That statute defines "wages" as the "earnings of any employee for labor or services rendered, regardless of whether the amount of earnings is determined on a time, piece, commission or other basis."

The Ruling

In *Beach and Vollero*, the Court found that the incentive compensation claimed by the employees did not constitute "wages" under the undisputed evidence and the language of the Labor Law statute, and therefore dismissed the employees' Labor Law claims. In reaching that determination, the Court followed an earlier decision by New York's highest court in *Truelove v. Northeast Capital & Advisory, Inc.*, in which the Court recognized that the concept of "wages" under the Labor Law is a limited one, and does not extend to every form of compensation paid to an employee. The Court in *Truelove* held instead that the statute's definition of "wages" contemplates a "direct relationship" between an employee's own personal performance and the compensation that is claimed, and specifically excludes "forms of incentive compensation that are more in the nature of a profit-sharing arrangement and are both contingent and dependent, at least in part, on the financial success of the business enterprise." Thus, because the employee's claimed bonus in *Truelove* depended upon his employer's overall financial success and was not directly tied to his own "personal productivity," the bonus did not constitute "wages" under the statute.

The Court in *Beach and Vollero* applied this same rationale to the undisputed facts before it, holding that the former employees' claims that they were entitled to be paid a percentage of the profits on the firm's investment books was not a claim for "wages" under the Labor Law. In making this finding, the Court observed that under the undisputed evidence, the profits on which the former employees based their claims "depended in part" on factors not directly linked to their personal performance, including the management and involvement of the investment funds' founder and "key man," contributions by other members of the investment team, and the overall success of the firm. The Court noted, for example, that the undisputed proof showed that the funds' founding member made investment decisions on the same investment books on which the employees based their claims, and that by the employees' own admission a "team" of individuals worked on those books and contributed to the books' overall profits and losses such that when specifically asked, the employees could not distinguish their own individual contributions to P&L in any given year. The Court noted as well that according to the plaintiff employees, the analysts were paid a discretionary bonus out of the amounts allegedly due the employees. As a result, the specific amounts claimed by the employees for each year varied based upon the contributions of the analysts, which were outside of the employee's control. Thus, while the employees might have enabled the analysts to perform more effectively, the Court observed that "they were compensated for their management through their $200,000 base salaries."

Significantly as well, the Court rejected the employees' claims under the Labor Law to recover earnings on the amounts that they claimed had been deferred and reinvested in the overall fund. The Court found that such compensation was "entirely outside" the employees' control, and also did not constitute wages under the Labor Law.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

In contrast, the Court cited to a situation in which an employee was promised a guaranteed bonus of a specific amount. The Court explained that such a bonus would amount to "wages" under the Labor Law because "as a salary substitute it directly compensated the employee for his personal services," and did not depend upon "the company's or a sub-set of the company's performance."

Ramifications and Lessons

New York's Labor Law can be a powerful tool for truly wage-earning employees who find themselves at the whim of their employers and at a significant economic disadvantage when their pay is withheld for no legitimate reason. At the same time, it is questionable whether the statute is appropriately applied to highly-paid senior employees in the financial services industry who are normally guaranteed and paid a significant salary, but who also frequently hope or even expect to be paid substantial additional amounts in the nature of profit-sharing or incentive compensation. The courts have generally rejected arguments that professional and executive level employees are completely exempt from the Labor Law. Yet at the same time the Courts have strictly adhered to an important principle: That for compensation to constitute "wages" and fall within the protections of the Labor Law, the sought-after compensation must be the product of individual effort or productivity and not in the nature of profit-sharing.

The implications of the decision in *Beach v. Vollero* are therefore significant for employers in the financial industry and the hedge fund industry in particular. It is often the case, for example, that hedge fund employees are compensated – whether in the form of a discretionary bonus or in a more formulaic structure – based upon the performance of identified portfolios or the firm as a whole. It is also the case that, regardless of a particular portfolio manager's skills, the very nature of portfolio management often involves contributions by persons other than a single portfolio manager, and that the performance of an investment portfolio will necessarily turn on an array of factors outside of the control of a single individual. Most portfolio managers, for example, rely upon investment analysts, risk managers and execution traders, or in the case of quantitative strategies, employees whose focus is on the underlying technology. Thus, in most cases the principles set forth in the *Beach* ruling would provide a strong defense to claims brought under the Labor Law.

Hedge fund firms can take straightforward steps to increase the likelihood that they will be protected by this ruling. For the most part, firms may do so by ensuring in written documents and other communications that performance-based compensation is not characterized as the product of any one individual's efforts, and instead is effectively a form of sharing in profits. This should not be problematic given the manner in which most significant portfolios are managed, but it is one area in which attention to detail can make a significant difference in reducing potential legal exposure. Adhering to this advice has the additional salutary effect of making it more likely that in a dispute over the right to claim responsibility for a "track record" or performance data, the firm will be in a stronger position vis à vis the individual. See "Portability and Protection of Hedge Fund Investment Track Records," Hedge Fund Law Report, Vol. 4, No. 40 (Nov. 10, 2011). Finally, hedge funds should ensure that each employee who has any chance to be paid supplemental or performance-based amounts is also entitled to be paid – and is actually paid – a fixed salary throughout the term of employment so that no traditional "wages" are withheld.

For a copy of the Decision and Order, click here.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Sean R. O'Brien is the Managing Partner of O'Brien LLP. His practice principally involves litigation and investigations arising out of complex financial transactions, shareholder and partnership disputes, as well as employment disputes. Mr. O'Brien has significant experience in representing hedge funds, their principals and employees in investigations and litigations.

Sara A. Welch is Counsel at O'Brien LLP and has over eight years of experience representing clients in disputes arising out of complex financial transactions and employment disputes. She has represented a range of clients, including hedge funds, private equity firms and individuals in partnership disputes, regulatory investigations and enforcement proceedings, commercial litigation, employment and partnership disputes, contract negotiations and other matters.

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL