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Employment

Best Practices for Fund Managers to Mitigate Litigation and Regulatory Risk Before Terminating Employees

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By Rorie A. Norton, *Hedge Fund Law Report*

The hedge fund industry has recently been battered by performance struggles and rising operating costs from increased regulatory pressures. Amid these circumstances, many fund managers find themselves facing difficult employee-related decisions – from which employees deserve bonuses to which warrant the proverbial pink slip.

While issuing performance bonuses is a purely financial decision, serious legal risks are associated with a manager's decision to terminate employees. In addition to the recent spate of SEC actions against employers alleging that provisions within their employment documents violated the SEC's whistleblower rules, there is also the risk of lawsuits from former employees who believe they were improperly terminated. For coverage of a wrongful termination suit against a fund manager, see "Four Recommendations for Hedge Fund Managers Designed to Minimize Risk and Damage From Employment Discrimination Lawsuits" (Oct. 11, 2012).

This article outlines certain steps fund managers should take prior to terminating employees – including reviewing their documentation and delivering feedback to poor performers – to mitigate regulatory and litigation risks. For more on important employment considerations for investment managers, see "Trending Issues in Employment Law for Private Fund Managers: Non-Compete Agreements, Intellectual Property, Whistleblowers and Cybersecurity" (Nov. 17, 2016); and "Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements" (Nov. 23, 2011).

Employment Documentation

The rapidly changing regulatory environment has caused agencies to increasingly focus on employment documentation language that may restrict current or former employees from exercising their statutory rights, explained Jones Day partner Martin L. Schmelkin. This includes the SEC, he noted, and its whistleblower program under Rule 21F-17 of the Dodd-Frank Act, which financially incentivizes employees to report violations to the SEC while also barring employers from impeding these efforts. For more on the SEC's whistleblower program, see "How Hedge Fund Managers Can Protect Privileged Internal Investigations Without Violating SEC Whistleblower Rule 21F-17" (May 21, 2015).

Arguably the most prominent SEC action was against BlackRock, Inc. for language in more than 1,000 separation agreements from 2011 to 2016 forcing employees to disgorge any awards they

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received for reporting violations under the whistleblower program. See "Lessons on Separation Agreements That Fund Managers Can Glean From Recent SEC Action" (Feb. 2, 2017). There have been at least four other SEC actions since August 2016, added Schulte Roth partner Holly H. Weiss, all of which targeted separation agreement provisions regarding confidentiality and non-disparagement. See "How Hedge Fund Managers Can Balance Protecting Confidential Information Against Complying With Whistleblower Laws" (Aug. 25, 2016).

Weiss argued that the language being attacked often was not intended to chill whistleblowing activity in the first place, adding, "These are the types of standard provisions that employment attorneys have been including in separation agreements for years." Further, while the SEC actions targeted separation agreements, these types of issues can arise in an array of document types addressed below.

Update Employment Documentation Templates

"Maybe the most critical pre-termination step fund managers should take," emphasized Weiss, "is to update their various form employment documents." This is important, added Schmelkin, because managers need to be able to move quickly on employment decisions – particularly those resulting in a termination – and do not have the time to simultaneously draft or revise the corresponding documents.

In light of this, Akin Gump partner Richard J. Rabin suggested that it is a best practice for managers to revisit their form agreements at least annually to ensure they are compliant. For additional insight from Rabin, see "Steps Hedge Fund Managers Can Take in Light of NY Attorney General's View That Certain Non-Compete Clauses Are Unconscionable" (Sep. 22, 2016); and "What the NLRB Complaint Against Bridgewater Means for Hedge Fund Manager Employment Agreements" (Sep. 8, 2016).

This exercise is warranted because of a couple of related issues common among managers. "Templates managers had in place a few years ago are simply outdated and almost invariably are non-compliant in this rapidly evolving regulatory environment," explained Rabin. Along this same vein, Weiss noted that many fund managers do not have many employees or, subsequently, much personnel turnover. "If nobody has been terminated for a long time, then simply reusing the separation agreement form last used years ago is not the most prudent idea."

Finally, beyond updating form separation agreements to mitigate termination risks, managers should revisit form onboarding documents for new hires, including employment agreements, offer letters and confidentiality agreements. This ensures that managers do not unwittingly introduce new sources of liability when hiring employees.

Additionally, Rabin noted that managers can ensure that key obligations and rights are in place by planning for the exit of an employee at the time he or she is hired. "Everyone is happy during this 'romance period' of the employment, and it's generally easier to negotiate key provisions – such as non-competition and garden leave – at that time than during a contentious separation."

For more on restrictive covenants, see "Impact on Private Fund Advisers of Obama Administration's and State Lawmakers' Actions to Restrict Use of Non-Compete Agreements" (Nov. 10, 2016); and "District Court Decision Suggests That Overly Broad Restrictive Covenants Will Not Be Enforced in Employment Agreements in the Wealth Management Industry" (Apr. 26, 2012).

Revisit Current Employee Documents

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Beyond ensuring that newly hired or terminated employees have appropriate documents by regularly reviewing form agreements, it is also a best practice for fund managers to regularly review the employment documents of their existing employees.

These documents can become outdated over time, which employers often realize at exactly the wrong time: when a problem arises, explained Rabin. “It’s only when a valued employee announces that he’s going to a key competitor that a manager bothers to look at the underlying employment agreement, only to discover that it is two pages long, is dated from 2006 and doesn’t help them (or, in some instances, harms them),” he noted. This is occasionally exacerbated by the fact that employees often grow into greater roles (*e.g.*, an analyst eventually becomes a portfolio manager), so the employment agreement provisions may have become antiquated, he added.

The most common method of updating existing employment agreements is for employees to execute a one-off supplement or addendum with revised language, explained Schmelkin. “It’s possible a whole new employment agreement would be warranted for a big position change, such as a new management function or title; otherwise, a one-off side agreement will usually suffice,” he added.

Weiss cautioned, however, that different approaches are warranted depending on the type of revisions the manager desires. If a manager simply seeks an addendum to reflect recent statutory or regulatory issues (*e.g.*, revising confidentiality provisions to meet SEC whistleblower requirements), then there are no real impediments to doing so.

On the flip side, if the addendum is meant to bolster restrictive covenants, then Rabin cautioned managers to ensure employees receive adequate consideration in exchange for these commitments. This can occur via a discretionary bonus, an increase in salary, a change in job title or the provision of some other benefit, he advised. While this can ultimately be advantageous for employers, Weiss pointed out that it also includes the risk that employees will want to simultaneously negotiate additional benefits for themselves. “It’s a can of worms that you may not want to open,” she added.

Review Policies and Procedures

On one hand, fund managers should have policies, procedures, employee handbooks, codes of conduct and the like describing misconduct that would result in discipline up to, and including, termination, Schmelkin explained. The types of issues that these should cover include confidentiality; travel and entertainment guidelines; anti-discrimination; and anti-harassment.

Beyond having these policies in place, Schmelkin emphasized the importance of ensuring each employee acknowledges in writing that he or she has received and reviewed the policies in their entirety – and that he or she actually does so. Additionally, fund managers need to provide regular training for employees on the items covered in these policies. This familiarity limits the likelihood of an employee being surprised if he or she were disciplined, he continued. “It ensures that employees know the rules of the game and the consequences if they violate them,” he added.

On the other hand, it is inadequate for fund managers to merely have policies and procedures that they have circulated to employees. The following are several reasons why it is imperative that managers review and update their policies and procedures regularly.

Outdated or Inapplicable Policies

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In a recurring theme, managers need to ensure their policies and procedures have not become outdated in light of recent regulatory developments. This review should occur with similar regularity, and for the same types of non-compliant provisions, as for the other categories of documents described above.

However, managers' policies and procedures sometimes contain provisions that the managers do not, in fact, implement, noted Rabin. Many managers – especially emerging managers – simply download their policies from the internet or repurpose them from another source, explained Schmelkin. Resulting issues can range from the policies not referencing the laws of the state where the manager operates, he noted, to being completely incongruent with the manager's operations.

Finally, Rabin noted that initial policies and procedures adopted by managers are often aspirational, detailing practices they would like to have instead of those they actually perform on a day-to-day basis. In light of this, managers should revisit them with an eye toward reflecting actual practices. "Don't say you are going to follow a certain policy or protocol unless you can absolutely commit to doing so," he advised. "Less is definitely more in a lot of ways."

Progressive Discipline Policies

Managers also need to review their policies and procedures to see if they contain a progressive discipline policy, which prescribes a company's course of action when disciplining employees (*e.g.*, initially issue an oral warning, escalate to a written warning and eventually terminate the employee). Often, a progressive discipline policy is included in a manager's policies if it was pulled off the internet, repurposed from another source or initially drafted in an overly aspirational manner.

There is some nuance to this. As described by Weiss, it is important for managers to have an internal progressive discipline policy for reprimanding employees. This can mitigate the risk of litigation by ensuring that clear and progressive attention is given to issues, giving time to cure them, she explained. "If they fail to correct the issues before being terminated, then at least they were not caught off guard," she added.

Additionally, Weiss noted that there is a real business incentive for managers to internally utilize progressive discipline policies. "If you have spent resources recruiting and developing an employee, you don't necessarily want to lose them just because he or she fails to perform up to par initially," she explained.

However, while Weiss firmly believes that it is beneficial for managers to have a progressive discipline policy, she is similarly adamant that managers should not distribute a version in writing to every employee. First, she explained that managers want to preserve flexibility by not binding themselves to these strict guidelines. "Just as doctors have the Hippocratic Oath to 'do no harm,' the same standard should apply to a manager's policies – managers should not implement any policies that unnecessarily do harm to their flexibility and options," concurred Rabin.

Echoing this sentiment, Schmelkin explained that there are obviously certain types of misconduct that warrant immediate termination, so managers should not have written progressive discipline policies which might optically appear to tie their hands. To the extent a manager has a progressive discipline policy in its handbook, then the policy must include a statement to the effect that nothing therein precludes employers from terminating employees immediately at will without proceeding through the prescribed disciplinary measures, he noted.

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However, this raises the question of whether there is any benefit to having, and widely distributing, this policy to employees in the first place, he added.

Further, Weiss explained how these policies introduce possible grounds for former employees to sue for improper termination. "A terminated employee can point to her employer's failure to perform step two of a five-step process in the policies as grounds for improper termination," she continued. Fund managers are particularly vulnerable to this, Rabin added, because it can often be difficult to perfectly comply with such policies in every scenario.

Delivering Negative Feedback

Employees tend to possess a cognitive bias called "illusory superiority," Rabin noted, which causes people to evaluate themselves higher, and think better of themselves, than others do. "This is the reason why 90 percent of people raise their hands when you ask them if they are an above-average driver."

Conversely, employers – particularly, hedge fund managers – exhibit "evaluation inflation," Rabin continued, where they avoid being completely honest when evaluating employees so as to not ruin morale. "In fact, sometimes managers skew so far in this direction that their evaluations can actually make poor-performing employees sound like they are doing quite well," he explained. "Managers will often suffer in silence and bemoan an employee's performance privately," he continued, "without ever telling them the cold, hard truth."

Combined, these traits mean an employer may not create a trail of documentation that an employee was performing poorly, while the employee will not have any reason to believe he or she was anything other than exemplary at his or her job. The resulting risk, according to Rabin, is that an employee's firing catches him or her by surprise and leads to allegations of discrimination, with the manager left scrambling to assemble evidence to refute these assertions.

To mitigate this risk, Rabin concluded, managers should give clear feedback to employees about how they need to improve so they are less likely to be surprised upon termination and file a lawsuit. To that end, the following are three important considerations for managers when providing feedback.

Timing of Feedback

Arguably the most important thing a manager can do, opined Schmelkin, is to provide real-time performance feedback to employees as projects are completed or as incidents occur. This ongoing dialogue "marks to market" where an employee stands in the eyes of their employer, while enabling the employee to hopefully improve their performance, he added. Unfortunately, many managers and supervisors shy away from delivering difficult and negative performance feedback on a consistent basis, he concluded.

Additionally, most fund managers have, or should have, processes in place to deliver formal annual and mid-year reviews to employees. As long as they are completed accurately, these reviews represent an ideal opportunity to capture anything negative about an employee's performance that had not been documented to date, Rabin noted.

Navigating Difficult Conversations

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Managers tend to avoid providing negative feedback to employees because they are uncomfortable doing so or, quite frankly, they do not know how. However, it is far better to get the difficult conversation out of the way than to put it off, particularly if the employee may refute or deny the claims. "If they are going to challenge your account of the conversation, it is better to have that information while they're still employed than to wait until the termination occurs," explained Rabin.

To overcome this hurdle, Schmelkin recommends that managers meet with their human resource (HR) departments in advance to prepare for difficult meetings. This can include having the manager participate in some roleplaying and having the HR team prepare a script or talking points, he explained. "Scripts keep the manager from veering off-message while also providing a written record if the content of the meeting is disputed in the future," he added.

Documenting Feedback

While an oral critique is better than no critique at all, a written critique is optimal because the parties will often remember those discussions differently upon termination, Rabin explained. Documented feedback is particularly valuable in the event of litigation. It provides support for the employer's assertion that the grounds for termination shouldn't have been surprising and that there was a legal, rational basis for the decision, Schmelkin explained. Additionally, it will help refute any allegation down the road by the terminated employee that the employee was terminated due to their protected category status (*e.g.*, age, race, disability, gender, etc.). "The more an employer can prove that a message was delivered loud and clear, the better," Schmelkin added.

Employee Countersignature

There is no single method for documenting feedback. The first approach to consider is whether to have an employee countersign the written feedback in agreement with its content.

Despite the upside of concrete evidence of agreement, suggested Weiss, the potential downside is substantial. "This can lead to a game of brinksmanship if an employee refuses to sign, which creates tension and a record of the fact that the feedback was contested," she explained. With that said, it is arguably okay to have an employee sign a written account stating that the meeting took place on a certain date and discussed certain topics, Schmelkin added.

Sharing Written Feedback

While documenting feedback is important for an employer's records, another consideration is whether to share that written record with the employee to provide the parties with a clear understanding of the issues in question.

Many fund managers send a follow-up email to the employee that is generally informal in tone (*i.e.*, "Thanks for speaking with me. As I mentioned you should do XYZ. Let's plan on catching up in a few weeks to discuss."), suggested Rabin. "This captures that a meeting occurred and keeps an employee from being able to deny it later, while also avoiding an unduly confrontational tone," he added.

Employee-Free Option

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The final, and perhaps best, approach is to avoid ever delivering written feedback to employees in the first place. Schmelkin recommended that a manager call or meet with HR personnel after providing oral feedback to an employee to recount the meeting to them. “Because HR personnel is well trained on how to capture and document the nature of a meeting, they can create appropriate notes of the conversation to preserve for future reference,” he explained.

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