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Human Capital Considerations For Maturing Private Equity Firms

By Michael J. Album and James E. Gregory, partners at Proskauer*

It has been roughly thirty-five years since the early pioneers of the private equity industry founded their start-up firms. A recent book recounts how the founders of one of today's leading firms borrowed office space and shared taxis to meet with potential investors.[1] During their formative years, these start-ups primarily were focused on raising capital and making the right investments; staffing and compensation issues were often secondary. The general partner teams were usually small, tight-knit and had many of the attributes (for better or worse) of a family. Thirty-five years later, many of these firms have thrived and evolved into major multi-asset franchises (some publicly traded) and have undergone significant organizational challenges.

As the industry has matured, the compensation, management and oversight of this "human capital" has taken on greater importance. This article is intended to provide readers with an overview of some of the legal issues we have encountered related to the management and compensation of human capital and the protection of the firm from inadvertent hiring or employment decisions that could adversely affect capital raising or a firm's reputation, or even expose the firm to criminal or other sanctions.

The issues addressed in this article include:

- Dealing with executive recruiting firms
- Investigating the background of candidates
- Compensating internal marketing personnel
- Vetting internal marketing personnel and other new hires to avoid regulatory fund-raising obstacles
- Structuring compensation to protect the firm as an "employer" (setoffs, clawbacks and loan forgiveness)
- Determining firm exposure under the new U.K. criminal bribery law

This article is intended as a reference source and as a platform to identify a variety of legal issues. We have written it for lawyers and non lawyers alike (and have limited case discussion to the footnotes). It is structured so that the reader can go directly to those sections of relevance.

Executive Recruiting Firms: Optimizing The Arrangement

One sign of the maturing nature of the private equity industry is the expanding use of executive recruiting firms to find talent for the management company, as well as various ancillary businesses and portfolio companies. In the early years, candidates often materialized as a result of the founders' business relationships and networking, with an emphasis on past associates or co-workers. As business operations have expanded, areas of need also have expanded well beyond core deal expertise, into back-office support, legal, tax and accounting, to name a few. In addition, as firms have grown they have branched out into new business areas, where a national executive recruiting firm is best suited to scour the available candidates or help execute a wholesale acquisition of a number of talented professionals to staff a new business operation. Given this background, a review of the salient legal terms of the executive recruiting relationship is warranted.

A firm's relationship with an executive recruiting firm raises the following key issues:

Exclusivity/Designated Team Members. Will the assignment be on an exclusive basis, and for how long? Who will be the key contacts at the search firm involved in the search, and is there a clear contractual commitment for designated and trusted personnel (i.e., a key person) to provide their services, and to avoid any unanticipated handoffs to new faces after the project has commenced?

Position Specification. Is there clarity regarding the position subject to the search, including the title and responsibilities of the position to be filled? Should there be a carve-out for any candidates previously known to the firm or referred by other recruiters and under consideration prior to the hiring of the executive recruiting firm?[2]

Fee Parameters. This involves fixing the fee as a percentage of the agreed-upon compensation, subject, if possible, to a cap so there is no open-ended exposure. Care must be taken to define the exact compensation payable to the candidate, which in turn drives the recruiting fee. Here are some practical questions to ask about the fee arrangement:

- Will it be contingent or also involve a retainer?
- Will it cover only direct cash compensation paid to the candidate, and, if so, only base salary and actual annual bonus paid during the first year of employment, or will it include a target bonus or some projected value attributable to multiyear cash incentive plans?[3]
- Will it cover the value attributable to promote or carry granted during the first year of employment, even if not vested until subsequent years?
- Will it cover make-whole cash payments paid in the first year of employment to compensate the candidate for forfeited carry or bonuses or other forfeited amounts attributable to prior employment?

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– Will it cover the cash value of other perquisites or relocation expenses paid during the first year?

– Will it cover the value of ancillary compensation earned during the first year (such as profits interests in ancillary investment vehicles)?

– What is the "tail" arrangement on the fee – i.e., if the arrangement is terminated before the search is completed, will the firm still owe fees if it fills the designated position with candidates presented by the executive recruiting firm within some designated period (e.g., one year following termination)?

Fee Refunds/Replacement Searches. What happens if the candidate is hired and then quits within a designated period? Will any portion of the fee be refundable to the firm, and, if so, how long will the protection period extend (e.g., six months from hiring)? Alternatively, what happens if the candidate is fired and it turns out that the firing relates to a problem that the search firm should have identified? Will the search firm conduct a replacement search at no additional cost?[4]

Apart from these primarily economic terms, there are some more general legal issues that also should be addressed. For example, the retainer agreement should make it clear that the executive search firm has no authority to extend any offers on behalf of the firm and that the firm retains absolute discretion to approve or reject candidates at its sole discretion. In addition, the retainer agreement should clearly establish that the executive search firm cannot poach any placed candidate, or any other professional employees of the firm, for some designated period, and this hands-off commitment should survive the cancellation of the retainer arrangement or a material change in the business.[5] Finally, counsel should carefully review any indemnity provisions of the proposed agreement to make sure that any indemnity obligation of the firm has the appropriate carve-out provisions so the firm has no indemnification obligation for acts or omissions by the executive recruiting firm that fall below market practice. On a related note, counsel also should review any exculpatory provisions or other provisions limiting liability in the retainer agreement to determine the extent to which a recruiting firm could be liable under the retainer agreement for its negligence and the subsequent activity of its candidates.[6]

Investigating Candidates: Authorization And Disclosure

Once the terms of the executive recruiting relationship have been established, the next step in acquiring human capital is verifying the candidate's background. As private equity firms have grown, the applicant pool for positions has expanded and personal verification of candidates may no longer be possible or adequate. Over the years, there also have been numerous situations involving financial fraud, Securities and Exchange Commission investigations, state attorney general investigations and other legal and regulatory proceedings that may have involved professionals who are now candidates for important positions at a firm. Then there is the additional fallout associated with personal misbehavior that may have been recorded for posterity on social networking sites or in emails, text messages or computer files. The upshot is that without an adequate background investigation, firms run the risk of hiring professionals who could jeopardize the fiduciary standards expected of GPs and tarnish hard-won reputations.

Background investigations can run the gamut from reference calls, to consumer credit reports and criminal record reviews, to the use of private investigators to conduct interviews and prepare extensive reports. The information surveyed could include past employment history, criminal records, court and bankruptcy records and social networking sites such as MySpace, Twitter, LinkedIn and Facebook.

Authorizing or conducting a background investigation may implicate federal laws such as the Fair Credit Reporting Act, or, if the results are used in a discriminatory manner, Title VII (the federal employment discrimination law), as well as various state laws that generally mirror their federal counterparts. Note that some states are even beginning to regulate when a firm can conduct certain types of background checks, and many states also have separate state laws governing the use of arrest and criminal conviction records in connection with considering applicants for employment. (For purposes of illustration, this article highlights the provisions of these leading federal laws and includes supplementary material in Annex A, which addresses state law in New York, California and certain other states.)

In many cases these laws, such as FCRA, have highly technical procedural provisions that require notice to, and the consent of, the targets of an investigation before the investigation commences, and notice to the targets if information is used to reject the candidate. In reality, the statutes tend to favor applicants, and because of their technical nuances, employers are at higher risk for inadvertently violating some provisions. As also one might expect, the employer's risk is exacerbated by the specialist plaintiffs' bar which seeks opportunities to allege violations and to litigate or settle.

As one will see from the discussion to follow, with its mind-numbing mix of acronyms, definitions and procedural trip wires, the legal regulation of background investigations is highly technical and outside the scope or competence of most in-house private equity professionals or non-specialists. Ironically, it is an area where the discovery of a significant criminal, credit or other background problem requires more careful analysis, rather than just an expedient rejection. It is an area where firm personnel need to rely on outside legal experts to review and approve the relevant documentation, where firms have to use reputable third-party investigators, and where firms again have to consult with outside legal experts before information uncovered in a background investigation is used for adverse employment purposes.

One additional practical point: The first line of defense when considering a candidate is the representations and warranties made by the candidate in the firm's offer or employment letter. The usual boilerplate requires that the candidate affirm that he or she is not subject to any non-compete or other restrictions and will not use confidential information from a prior employer. These "reps and warranties" can be expanded, however, to bring to light a range of prior activity that may disqualify the candidate from further consideration, with the breach of the representation constituting grounds for termination for cause if the candidate misrepresents matters and is hired.[7]

Fair Credit Reporting Act. This is the leading federal law that governs background investigations of job applicants by private employers. Despite its title, the law is not limited to consumer credit matters, and although its terminology has a consumer feel to it ("consumer reporting agencies," "consumer reports" and "investigative consumer reports" are terms used throughout the statute), private equity firms, venture firms and asset managers all may fall within its scope. Moreover, the FCRA does not just apply to applicants; it also may apply to background investigations directed at employees if, during the course of employment, an employer suspects misconduct.

It is important to note that the FCRA applies when an employer retains an outside company – a so-called consumer reporting agency – to conduct a background check of its applicants or existing employees, or even of outside independent contractors. It does not apply to situations where the employer conducts the background checks in-house. There are, however, clear advantages to using an outside third party to conduct an investigation, in addition to the expertise and time commitment they can bring to the task. The FCRA helps protect employers who use consumer reporting agencies to perform background checks by providing immunity in suits that allege defamation, invasion of privacy or negligence in connection with the investigation.[8] So using an outside agency may be a better option.

As a matter of terminology, a consumer report is any communication from a consumer reporting agency bearing on a consumer's creditworthiness, standing or capacity, character, reputation, personal characteristics or mode of living, and includes criminal background checks, credit reports (showing outstanding debt, credit arrangements and related matters), education verifications, employment verifications, reference checks and driving records checks.[9]

Under the FCRA, employers who use consumer reporting agencies are responsible for ensuring applicants/employees are aware that consumer reports may be used for employment purposes and must consent to allowing the employer to procure the information (both in connection with the application and subsequent employment if the applicant is hired); and notifying applicants/employees immediately if information contained in their consumer reports may result in a negative employment decision. So the first priority under FCRA is for a firm to have proper documentation in place that notifies applicants/employees that an investigation is taking place, and to obtain the written consent.

Further, whenever an employer is considering making an adverse employment decision, such as refusing to hire, terminating, denying a promotion or demoting an employee, based in whole or in part on an applicant/employee's consumer report, the FCRA requires that the employee or applicant be notified. An employer must send the individual a pre-adverse action disclosure indicating information in the background screening report may cause employment to be denied and must provide the individual with a copy of the background report and an FTC notice entitled "Summary of Your Rights Under the Fair Credit Reporting Act." Although the statute does not specify the intervening time period before the employer can take an adverse action based on the information, the Federal Trade Commission has indicated five business days is a reasonable time period to wait after the pre-adverse action letter before taking the adverse action.[10] The FCRA also requires that the employee or applicant be provided with oral, written or electronic notice of the adverse action once it has been taken.

With respect to existing employees, amendments to the FCRA provide some relief for employers who wish to investigate employees who engage in post-hiring misconduct. In particular, the amendments exclude from the definition of a consumer report communications made to employers in connection with an investigation of suspected misconduct relating to employment; compliance with federal, state or local laws and regulations, the rules of a self-regulatory organization, or any preexisting written policies of the employer. As a result of these amendments, employers can hire outside consultants, investigators or law firms to investigate and report on a variety of workplace issues without having to first notify the target of the investigation or obtain his or her consent. However, if the investigation gathers information related to an individual's creditworthiness, credit standing or credit capacity, the notice and consent provisions of the FCRA still apply. If an employer has secured broad consent at the time of hiring, which covers post-hiring employment matters, an employer may rely on this prior written consent and avoid seeking consent for the investigation.

As mentioned above, certain states such as Connecticut and Maryland recently have gone beyond the FCRA to limit when an employer may even investigate credit information as part of the employment process. These state initiatives are described in Annex A.

Title VII of The Civil Rights Act of 1964. Further, improper use of consumer reports and criminal records may implicate Title VII. Specifically, Title VII prohibits discrimination on the basis of race, color, sex, religion or national origin.[11] In particular, Title VII prohibits any employment practice that disproportionately screens out racial minorities, women or other protected groups, unless the practice is job-related and consistent with a business necessity. Thus, if an employer's use of criminal or credit background information disproportionately excludes African-American, Hispanic or other protected candidates, the practice could constitute unlawful discrimination, unless that employer can establish that the practice is needed for it to operate safely or efficiently.[12]

State Laws Governing Use of Conviction and Arrest Records. Title VII is a statute that applies to alleged discrimination that could arise from the use of conviction or arrest records. A number of states go one step further and make it unlawful for any employer to take adverse action against an applicant based on arrest records. Several states also restrict the use of convictions, unless there is a clear relationship between the crime underlying the conviction and the position at issue. A further discussion of the laws governing the use of arrest and conviction records in New York, California and certain other states is set forth in Annex A.

Hiring Internal Marketing Personnel: Regulatory Considerations

Moving past general recruiting and hiring issues, in recent years many private equity firms have focused on building internal marketing and capital-raising expertise. This trend has been fostered both by a desire to reduce the cost of fund raising, as well as the adoption of policies by public investors restricting investments in firms that use third-party placement agents.

There are, however, special legal issues to be reviewed when hiring individuals for internal marketing positions. First, employers have to ensure that the compensation arrangements are structured to satisfy SEC regulatory concerns regarding broker-dealer activity. Second, employers who hire internal marketers need to ensure that these individuals have not engaged in political contributions or other activity that could run afoul of new pay-to-play legislation. Third, use of internal marketers may require that the private equity firm and the marketers themselves register as lobbyists in some jurisdictions.

The SEC and Broker Registration/Compensation Issues.

Employees being hired in-house to raise capital have a natural and rational desire to replicate their lucrative external compensation arrangements: a base salary plus a percentage of capital raised, often with tail protections to provide for continued commission payments on such capital if the external placement firm is terminated.

This arrangement is usually permissible when the employee is employed by an external placement firm because that firm will be registered as a broker-dealer under federal securities laws, and, as an employee of the placement firm, the employee will be an individual associated with the registered firm operating under its supervision, and will have no independent individual obligation to register as a broker with the SEC (though the individual likely would have to register as a representative with the applicable self-regulatory organization, or SRO).[13]

The problem arises when the employee leaves the registered firm and joins a private equity firm that may not be a registered broker-dealer. The key to SEC involvement and regulation in the area is the broad legal definition of broker, which Section 3(a)(4)(A) of the Securities Exchange Act of 1934 (the "Act") defines as "any person engaged in the business of effecting transactions in securities for the account of others." Most brokers, in turn, must register with the SEC (by filing a Form BD and securing SEC approval) and must register with the applicable SRO. SEC regulations, in turn, impose a range of reporting, trading, financial responsibility (e.g., capital), anti-fraud and operational restrictions on registered brokers.

If the broker registration provisions of the Act are violated, there could be regulatory ramifications for the broker-dealer and for the issuer whose securities have been sold. The Act (Section 29(b)) also provides that contracts made in violation of the Act may be voidable, which could include both the agreement entered into with the unregistered broker and subscription agreements between investors and a fund secured by the unregistered broker.

In its guide to broker-dealer registration, the SEC has focused on marketing personnel as falling within the scope of the broker definition, expressly referencing individuals who find investors or customers for funds or issuers and whose compensation is dependent upon the amount of capital raised. The SEC staff has stated specifically that percentage-based commissions in connection with securities transactions are "a hallmark of broker-dealer activity."[14]

The SEC also has recognized an exception for issuers of securities (the "issuer's exemption"), since issuers generally sell securities for their own account and not the account of others.[15] The SEC has created an ancillary "safe harbor" for employees of issuers pursuant to Rule 3a4-1 related to this issuer's exemption. The rule provides that employees of issuers involved in raising capital through the sale of securities do not have to register as broker-dealers if such employees engage in limited sales activity that does not generate compensation, directly or indirectly, based on securities transactions.

The problem with this safe harbor is that it is very difficult for a marketing employee who wants to move in-house to replicate his or her commission arrangement without losing the protection of the safe harbor and having to register as a broker-dealer. The safe harbor is not the exclusive means to establish non-broker status, and this is an area where there is little guidance, so if the safe harbor is not applicable, the risks associated with a "facts and circumstance" test may not be acceptable. (Of course, if the private equity firm has a registered broker-dealer entity, then the new hire can be structured to either be employed by or provide services under the supervision of such entity and the problems discussed below should be alleviated.)

The practical shortfalls in the issuer's safe harbor include the following provisions:

- the employee cannot be compensated by the payment of compensation or other remuneration based either directly or indirectly on transactions in securities (i.e., sales of fund interests);
- after the capital is raised the employee must primarily perform for the issuer substantial duties other than in connection with sales of fund interests; and
- the employee cannot have been associated with a broker or dealer within the 12 preceding months.

At the end of the day, then, the safe harbor generally precludes the precise commission arrangement the candidate wants and also may disqualify a candidate who is actively associated with a broker-dealer immediately preceding the anticipated hiring (i.e., the candidate would have to "go stale" for 12 months prior to hiring and, in the process, jeopardize his or her contacts and fund-raising connections).

So what is a firm to do when hiring an internal marketer?

- Most importantly, shift the compensation arrangement away from commissions on capital raised; instead focus on base salary, discretionary bonus or a bonus formula tied to net profits of the firm.
- Make sure the candidate has substantial responsibilities that continue after the termination of the capital-raising period (e.g., continued investor relations responsibilities).
- Consider the possibility of having an affiliated entity register as a broker-dealer.

In addition, firm counsel must check the broker-dealer laws of the states in which the firm has offices. State law may impose registration requirements on internal marketers that do not have to register as broker-dealers on a federal level.

Current Pay-to-Play Regulations and Lobbyist Registration Requirements. Another problem area when considering the in-house hiring of marketers involves the new patchwork of regulations arising out of the pay-to-play scandals and related matters.

SEC Rule 206(4)-5. Effective as of March 14, 2011, this SEC rule prohibits investment advisers from receiving compensation for advisory services provided to government entities for two years after partners, members or certain employees (so-called "covered associates") have made contributions to a government official who can directly or indirectly influence the government entity's choice of investment advisers (or appoint someone who can directly or indirectly influence such choice).[16] Since this two-year time-out is triggered by contributions made by covered associates – any general partner, managing member, executive officer of the adviser, or any employee who solicits a governmental entity for the adviser (or any supervisor of such employee) – the hiring process should be structured so the candidate discloses in advance any disqualifying contributions, and, if such contributions have been made, the firm can avoid making an offer. This vetting process is critical because the two-year time-out will continue to apply even if the disqualifying employee has resigned or been fired. It is also the case that prior contributions follow an individual who is promoted and becomes a covered associate, so the political contributions of any candidate being considered for promotion to a covered associate should be vetted in advance as well.

California AB 1743. In 2010, California enacted Assembly Bill 1743 ("AB 1743"), which became effective Jan. 1, 2011 and requires placement agents who transact business with California's statewide employee retirement funds – California Public Employees' Retirement System and California State Teachers' Retirement System – to register as lobbyists and prohibits the receipt of compensation contingent on the investment decisions of such entities.[17]

The definition of placement agent under AB 1743 is not limited to outside third-party placement agents, in that it references "any individual hired, engaged, or retained by, or serving for the benefit of or on behalf of, an external manager…who acts or has acted for compensation…in connection with the offer or sale of the securities, assets or services of an external manager."

There are exceptions to the definition of placement agent for employees and others who spend one-third or more of their time "managing the securities or assets owned, controlled, invested or held by the external manager" (the so-called "one-third" exemption); and firms that qualify under a three-prong competitive bidding exception (firms that are registered advisers or broker-dealers with the SEC, have been selected through a competitive bidding process, and have agreed to a designated fiduciary standard of care). Putting aside the competitive bidding exception, firms will have to determine whether an internal marketer who is not involved in actual portfolio investments but who is involved in a range of investor relations functions (other than fund raising) can qualify for the "one-third" exemption.

New York/New York City. New York also has witnessed significant recent developments regarding placement agent use and compensation, at both the state and city levels. As a result, third-party placement agents largely are precluded from soliciting the most active public pension plan investors in New York.[18]

Also, in December 2010, the New York City Clerk's Office distributed a legal opinion to private equity managers advising that in-house marketers and their employers were required to register as lobbyists under New York City's lobbying law (the "NYC Lobbying Law").[19] The NYC Lobbying Law contains an exemption from lobbyist registration for a private equity manager's employees "who are charged with the performance of functions relating to contracts," provided that they do not solicit actual elected offices or their deputies.[20] We understand that, in interpreting this exemption, the NYC Law Office has advised that employees who limit sales-related activities to responding to an RFP issued by New York City or responding to diligence inquiries from investment staff need not register as lobbyists. However, a manager's employees who initiate the sales process with New York City or otherwise attempt to influence the manager selection process would be required to register as lobbyists. Registration as a lobbyist under the NYC Lobbying Law precludes an in-house marketer from receiving compensation contingent on New York City investment decisions.

Protecting The Compensation Structure Of The Firm: Setoffs, Clawbacks And Loan Forgiveness

Assume the firm has made it through the hiring and investigative process, and has hired and is properly compensating its new internal marketing staff. The firm also should consider whether it has implemented fully a range of techniques designed to protect the firm from compensating professionals who, it turns out, do not exactly play along with the team. Consider the case of a partner who defaults on a capital obligation, a partner who competes following his or her departure and triggers a clawback obligation on compensation previously paid or a partner who leaves before a loan is fully forgiven. In these situations, the firm may find it useful to have implemented certain measures in advance, so it can exert maximum leverage.

Maximizing Setoff Rights against GP Team Members. As successful private equity firms become more complex and sophisticated, so too do the financial rights and obligations of the GP team members. For example, consider the following typical compensation arrangements:

– GP team members receive annual cash payments from the management company. For lower-level executives this may be in the form of W-2 compensation; for more senior executives who are partners it may be in the form of guaranteed partnership distributions reported on a Schedule K-1.

– GP team members at the W-2 level receive discretionary year-end bonuses.

– GP team members may acquire capital interests in multiple GP carry vehicles (associated with different vintage investment funds), pursuant to which they are obligated to make capital calls as required from time to time.

– GP team members receive carried interests in multiple GP carry vehicles (associated with different vintage investment funds), pursuant to which they are entitled to receive profits distributions upon certain liquidity events (portions of which may be subject to escrow or holdback accounts, and distributed at later periods).

– GP team members may be subject to clawback obligations under these multiple GP carry vehicle documents, and also may have executed separate freestanding guarantees for the benefit of investors.

– GP team members may have deferred cash arrangements providing for the future vesting and payment of cash bonuses or other compensation deferred for retention or other purposes.

– GP team members may have co-investment obligations and repayment obligations under leveraged financing arrangements that fund the co-investments.

– GP team members may be required to repay tax advances or deemed capital contributions if terminated or retired.

When all is going according to plan, and GP team members are acting in concert, this myriad of relationships is manageable, and cash flows and related payment obligations can be handled in a rational manner. The problems arise when a GP team member's interest turns adverse to the rest of the team. This can occur when the GP team member resigns, retires or is involuntarily terminated or demoted.

In these situations the targeted GP team member can no longer be relied upon to fund ongoing payment obligations and may be looking for ways to avoid putting cash back into the hands of his or her former associates; GP team members can be expected to respond in a negative (and visceral) manner to paying out significant amounts to disfavored or former team members, when the same team members have defaulted on capital commitments or clawback or other payment obligations.

In these cases, the managers often will look to self-help to avoid allowing cash to flow out of the GP's control to the targeted team member. Thus, the managers of the GP may seek to unilaterally apply (or set off) amounts owed to the targeted team member against amounts owed by the targeted team member, with only the net amount, if any, allowed to be paid to the targeted team member (or former team member).

The ability of the GP managers to set off may not be available in the absence of carefully drafted documents that expressly provide for such setoff rights. That is because, absent proper drafting, the right of setoff is often only a creature of common law, which means it derives from a set of judicially crafted rules that are technical and may not apply to all facts and circumstances. In addition, and especially for lower-level employees, state wage laws may protect earned wages from being subject to setoff, and violations of these laws can expose an employer to penalties and regulatory action. Finally, efforts to set off deferred compensation could result in the violation of tax laws that impose penalties on wrongfully accessing deferred funds prior to established payment dates.

All in all, this is a very complicated area that requires review of the full range of GP documentation by experienced counsel. What follows is a short review of the various issues relating to common law setoff, certain prohibitions on setoffs against earned wages or deferred compensation and the drafting steps that can be taken to provide a firm contractual basis to allow for setoffs to the maximum extent permitted by law.

Common Law Right of Setoff and Drafting Express Setoff Rights. Courts have long recognized that parties who may owe each other money should be subject to a netting of amounts owed. To that end, the doctrine of setoff allows entities that owe each other money to apply their mutual debts against each other, "thereby avoiding the absurdity of making A pay B when B owes A."[21] At the same time, there are certain rules for allowing setoff and simply because a GP manager claims the right to setoff does not mean that it will be recognized at law. Generally, setoff will be permitted even if the payment obligations arise from different transactions, but only so long as the claims have mutuality and involve the parties in the same capacity.[22]

In practical terms, mutuality requires that the claims be fixed in amount and liquidated – if one claim is alleged but contingent it is not good enough. In one leading case, a private equity manager withheld fund distributions to a former team member because that team member allegedly owed funds back to the manager.[23] In rejecting the manager's right to set off the distributions due from the fund, the court held that the alleged payment obligations of the former team member were not liquidated (i.e., were not fixed and undisputed) but only contingent, and that as a result there was no mutuality of claims to allow for setoff. In another case, the court found that parties were not claiming amounts due in the same capacity because some amounts were subject to an escrow arrangement and others were simply claims of an unsecured creditor.[24]

Given the technical issues in this area, the better approach is to provide for express setoff rights in the operative documents affecting GP team members. For example, in the section of the GP agreement dealing with defaults in the payment of capital, the remedies available to the GP could include an express right of setoff of all amounts due or payable to the defaulting member from any affiliate of the GP. This will pick up payment obligations from the full affiliated group, which in today's world could include not just a series of multiple private equity investment funds under management, but affiliated alternative investment vehicles and operations. The operative documents for these affiliated entities also should provide for a corresponding reference to and acknowledgement of this setoff right so there can be no dispute that all the affected payment sources have agreed to and have authority to implement the setoff remedy.

Limits on the Right of Setoff. Even if these drafting steps are taken, there still may be some types of payments that cannot be subject to setoff. First and foremost, earned wages may not be subject to reduction or setoff under various state laws. The key inquiries here are whether the amounts in question are wages and whether they have been earned. Base salary earned by W-2 employees for a particular payroll period cannot be subject to setoff. The same generally holds true for formulaic bonus amounts tied to the personal productivity of an employee and that have been earned under the applicable formula. Other types of compensation, such as allocations from discretionary bonus pools established at year-end, phantom equity interests and deferred compensation that has expressly been identified as contingent and not earned until paid, raise closer questions, and counsel should be consulted before any of these amounts are subject to setoff.[25]

Setoffs affecting deferred compensation arrangements also may trigger issues under Section 409A of the Internal Revenue Code but only to the extent that funds of the employee being accessed are, in fact, "deferred compensation." The basic purpose of Section 409A is to limit an employee's control over the timing and payment of previously deferred compensation. To satisfy the requirements of Section 409A, a deferred compensation plan must provide for compensation deferred under the plan to be paid only on very limited payment events: a fixed date, separation from service, change in control, disability, death or unforeseeable emergency.[26] Violations of Section 409A incurred by impermissibly accelerating access to deferred funds can result in substantial additional taxes and penalties to the employee-taxpayer and even penalties to the employer. Generally, offsets permitted under Section 409A are limited in time and amount, so the threshold issue is for the employer to make sure – in consultation with counsel – that the amounts subject to setoff are not deferred compensation covered under Section 409A.[27]

Employment-Related Clawbacks. Another technique designed to protect the firm from compensating employees (or former employees) who no longer play by the rules, or otherwise merit redress, are compensation recovery arrangements, commonly referred to as clawbacks. A number of highly publicized legislative changes in the U.S., including the Sarbanes-Oxley Act of 2002 and Troubled Asset Relief Program (TARP) rules applicable to some recipients of federal assistance, mandate clawbacks for certain entities.[28] Most recently, Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires that every listed public company in the U.S. develop a clawback policy and mandates that the SEC issue regulations addressing clawbacks.[29]

Although these legislative mandates do not apply to the vast majority of private equity firms, which are either privately held or otherwise exempt, there is no reason that firms cannot adopt these approaches to protect themselves in their capacity as employers.

A brief note on nomenclature: We are not speaking here of the investment performance clawback in favor of investors that protects investors from the potential for a mismatch between a fund's total performance and a manager's paid-out promote or carry. If a manager receives carry throughout the life of a fund, but the fund's investments ultimately perform poorly so that the investors do not achieve their targeted amount of distributions, the performance clawback protects the investors from being shortchanged on distributions. Firms routinely have imposed a corresponding clawback obligation on GP team members for their pro rata share of any GP performance clawback obligation, and investors also may seek freestanding separate guarantees from GP team members to secure further this clawback obligation.

The clawbacks we are addressing here are not triggered by the mismatch between carry and fund performance, but instead relate generally to all payments of compensation by the firm to its employees. In contrast to fund performance clawbacks, employer clawbacks of payments previously made to employees (or former employees) in the employment context are for the employer's own protection. The rationale is multifold – namely to deter or punish employee wrongdoing, to enforce post-employment covenants, or to recoup payments that were made improperly. Before a private equity firm implements an employment-related clawback program, it should assess carefully the pros and cons of requiring such clawbacks, consider certain design features and anticipate employee reaction.

To the extent a payment is based upon flawed accounting (such as in connection with a bonus program tied to net profits), a clawback should not be controversial since it is merely correcting a computational error (and adjustments can be negative or positive). Many employers also require that all or a portion of signing bonuses, headhunter fees or relocation expenses (or in some cases, immigration or visa expenses incurred by the employer) be repaid if an employee quits before a specified date or is terminated for cause; these also are considered fairly standard and not terribly controversial with employees.

Somewhat more controversial, however, are clawbacks designed to recoup amounts paid to an employee who has engaged in misconduct leading to a termination or with respect to a former employee who violates post-employment restrictive covenants, such as non-competition, non-solicitation (of employees, clients, customers and/or investors) or more general non-interference or non-disclosure agreements. (e.g., relating to track record use).

A clawback policy too aggressive or too broad in scope, however, could be counterproductive if it discourages desirable risk taking, dissuades potential candidates or otherwise negatively affects employee morale or motivation. Most employees tend to view compensation on an annual basis and consider salary and bonus payments to be final when paid and generally not subject to subsequent and contingent events. Even well-compensated employees and fund managers are reluctant to assume continuing liability for payments already received. Sophisticated employees will discount such payments and may even seek additional cash up-front to compensate for the contingent liability.

Clawback Mechanics. In developing a clawback policy or strategy, a private equity firm must consider multiple options and variables, including what types of payments to claw back (e.g., bonuses, deferred compensation, carried interest or portfolio company option gains, restricted stock payments or other equity-based awards); when to measure the value of such payments (for example, in the event of an equity-based payment, upon vesting/exercise or the subsequent disposition of the interest); how long a payment should be subject to a potential clawback (i.e., the so-called look back period); and whether repayments should be based on the pre-tax or after-tax amount of the payment subject to clawback (which may depend upon the anticipated tax treatment of the repayment, as discussed below).

Practically speaking, unless a clawback is specifically provided for and agreed to up front by the employee, it will be difficult to enforce. As was witnessed during the financial crisis, companies (and governments) are reluctant to pursue compensation already paid (even with respect to senior executives who have received large payments from failed institutions) unless there is a sound contractual and legal basis to recoup such funds. In contrast to the more straightforward process of holding back funds that have not yet been paid or forfeiting unvested or other deferred amounts that are still held by the employer (often pursuant to the so-called "employee choice doctrine" if the employee voluntarily quits),[30] enforcing a clawback often means initiating collection efforts against the employee. Employers cannot assume that a former employee will voluntarily surrender previously paid monies (which may already have been spent) merely in response to a request or even a legal demand. In addition to the expense of litigating against a former employee, the employer also must weigh the potential negative publicity and the uncertainty of the outcome. These types of cases also may result in counterclaims by the former employee for breach of contract, wrongful discharge or other employment law claims (e.g., whistle blower-type claims).

Tax Treatment of Clawbacks. Clawbacks raise some potentially complex tax issues as well. Generally, if the payment and the clawback occur in the same tax year of the employee, there should be no taxable income to the employee and no need to take a corresponding deduction for the payment (i.e., the transaction is treated as never having occurred and will have no income tax implications whatsoever).[31] If, as is more often the case, the clawback is retroactive (i.e., the payment was received in a year prior to the year of the clawback), the tax analysis is somewhat more complicated. The employee is not permitted to amend the return for the year of payment, but the employee may be able to claim an itemized deduction for the year of repayment under Tax Code Section 162 (as an unreimbursed business expense) or Tax Code Section 165(c)(1) (as a loss incurred in the trade or business of being an employee).[32] Because both of these provisions limit deductions to amounts in excess of 2% of adjusted gross income (and these deductions remain subject to phaseout and possible application of the alternative minimum tax), the full tax benefit of the repayment may not be realized by the employee.

In certain specific cases, the employee may be able to realize the full tax benefit of the clawback repayment by invoking Tax Code Section 1341, which codifies the so-called claim of right doctrine. Section 1341 provides rules for the computation of tax where a taxpayer is entitled to a deduction in excess of $3,000 as the result of restoring an amount included in gross income in a prior year because it then appeared the taxpayer had an unrestricted right to such amount.[33] Section 1341, where applicable, allows the taxpayer to calculate income tax in the repayment year as the lesser of the tax calculated by deducting the repayment for that year; or the tax calculated without the deduction, but reduced by a tax credit in an amount equal to the income tax attributable solely to the payment in the prior tax year (or years) it was received. Because the Section 1341 computations are made without the 2% floor (and apply to all taxes, including the alternative minimum tax), and the taxpayer chooses the computation that will render the better tax result, Section 1341, if applicable, should make the taxpayer whole with respect to the tax liability incurred on the initial pre-clawback payment.

The Internal Revenue Service historically has attempted to construe narrowly Section 1341.[34] In more recent years, the courts have applied Section 1341 more broadly where the so-called "same circumstances test" has been met. Under this relatively favorable standard, application of Section 1341 turns on whether the repayment involves restoration of the same item paid in an earlier year – that is, whether the initial payment was paid based on specific assumptions or expected conditions agreed to at the time of the initial payment and the repayment is triggered because those conditions or assumptions have not been satisfied (e.g., violation of a non-compete where the initial payment was premised on compliance with a non-compete).[35] Given the complexity and uncertain nature of the law in this area, both the employee and the employer should seek experienced tax counsel in connection with reporting a clawback transaction.[36]

Section 409A and Wage Law Consideration. With respect to former employees, the employer also may be tempted to withhold clawback amounts against severance or other post-employment payments. Employers must be cautious, however, since many post-employment payments also may be treated as non-qualified deferred compensation governed under Section 409A. The particular risk here is with the so-called substitution rule under Section 409A, which may be implicated if the employer seeks to apply deferred compensation to satisfy a clawback obligation, and the payment on behalf of the employee results in the accelerated release of deferred compensation (an impermissible payment acceleration). In addition, state wage laws may protect certain types of payments from offset or reduction as mentioned in the separate discussion above regarding permissible setoff rights.

In sum, although clawbacks appear to be in fashion, they involve significant complexity and are challenging to implement. There are many good reasons why a private equity firm might include clawbacks in its employment arrangements and/or compensation policies, but employers can expect substantial pushback from employees if the clawback policy is viewed as too aggressive, too broad in scope, or otherwise unreasonable under the circumstances. Given the multiple potential tax, wage law and state law pitfalls, employers should consult with experienced counsel before they attempt to implement clawback programs or exercise their rights thereunder.

Employee Forgivable Loans. Employee forgivable loans may offer employers an alternative retention and recoupment mechanism. Because these arrangements may be challenged by the IRS as not constituting bona fide loans, employers should proceed with caution in using them.[37]

Forgivable loans most often arise in connection with a new hire, but also may arise in connection with co-investment programs or other funding arrangements. A forgivable loan typically might work as follows: The employee receives an advance that is treated as a loan, as opposed to compensation, and is not subject to withholding or payroll taxes; the employee signs a note agreeing to repay the amount of the loan advance, with stated interest, in set installments over time (and to pay attorneys fees if the note is subject to default); the note has express setoff provisions; the employee directs or authorizes the employer to offset any future bonus or other payments against principal and interest due; and if the employee quits or is terminated for cause before the loan is repaid, the full unpaid amount of the loan, plus interest, is accelerated and becomes due. Provided the employee remains employed over a specified period of time, the loan also may be forgiven (usually in installments) over such period (or may be forgiven upon death, disability or termination without cause), with the employee recognizing taxable income upon such forgiveness.

At first glance, the forgivable loan appears to have several advantages. First, if structured properly, the advance is not taxable to the employee, meaning the employee gets the full benefit of the cash up front. Second, because repayment of the loan is accelerated upon the employee's voluntary resignation, the loan (and threat of repayment) acts as a retention device. Third, if the employee quits, the employer can execute setoff rights or sue for repayment under the note, which normally should be a fairly straightforward collection action (i.e., principal plus interest plus attorneys fees and costs of collection). Moreover, the employee may find it difficult to argue that the repayment feature is an unenforceable penalty or liquidated damage provision (since the employee/borrower actually received the money up front).

These actual or perceived advantages, however, must be weighed against several potential drawbacks, including these: The employer does not get an income tax deduction when the loan is made (which may be material to the taxable employer); as the loan is forgiven, taxable income without cash (i.e., phantom income) is realized by the employee; upon such forgiveness, a withholding obligation arises for the employer; and depending upon how the loan is structured, there may be some risk that the loan will not be respected for tax purposes, as explained below.

Under long-standing IRS rulings, an employee loan arrangement that lacks the required "indicia of bona fide indebtedness" will be disregarded for tax purposes and treated as a compensatory arrangement, meaning the money loaned will be taxable to the employee when advanced. Whether a bona fide loan exists for tax purposes is a factual issue that depends on the circumstances of the particular transaction. The more characteristics of a loan that are present, the greater the likelihood that a transaction will be treated as a loan for tax purposes.

The IRS has found that a purported loan was, in fact, compensation for tax purposes where a separate bonus agreement was entered into that tied the amount and timing of the bonuses to the amount and timing of installments due under the promissory note.[38] By synchronizing the amounts and timing of the bonus and the loan payments, the employer may invite the IRS to question the true nature of the transaction and whether there was a real expectation that the employee would be required to repay the loan with personal funds. On the other hand, the IRS has recognized that a debt can be discharged through the performance of future services.[39]

Thus, employers who elect to use forgivable loans should avoid scheduling bonus payments under a separate agreement to be made at the same time and in the same amounts as installments becoming due under the promissory note or other loan document. In order to give reasonable assurance of payment by the employee, the promissory note or other loan document also should provide that any failure to make a payment of principal or interest when due will result in accelerated maturity of the debt. It is also preferable that any future bonus amounts to be paid to the employee be paid directly to the employee and not applied directly against the debt. To avoid imputed interest under the tax laws, and to provide additional bona fides for the loan, the note also should provide for adequate stated interest (at no less than the applicable federal rate).

Protecting The Firm In The UK: The New Criminal Bribery Law

Given the growing international scope of private equity today, we thought it appropriate to close this overview of human capital issues with some observations on the new U.K. Bribery Act. Having worked through more routine human capital issues, the issue of policing the workforce becomes more challenging as private equity firms grow their international operations. The U.K. Bribery Act offers an example of risks arising from actions by employees and others that can result in criminal liability for the firm, and the need for the firm to implement protective measures, including anti-bribery procedures.

On July 1, 2011, new U.K. legislation to combat bribery and corruption came into force. Its implementation was delayed, largely due to controversy arising out from fears that these rules are stricter than bribery laws in other jurisdictions, thereby making the U.K. uncompetitive as a commercial center. So was this controversy justified, and what steps should those within the private equity industry be taking to ensure compliance with the new regime?

As to the controversy, contrary to reports, the new legislation does not materially broaden the scope of what constitutes unlawful conduct under the old legislation. Many have criticized the new law by focusing on its prohibition against facilitation payments (i.e., unofficial payments paid to facilitate or to expedite routine action), and its extraterritorial scope. However, neither is new – the old law also prohibited facilitation payments and had extraterritorial scope. Indeed, there are good arguments that the new law merely succeeds in clarifying and simplifying the previous law. This is illustrated by the refreshing simplicity of the three clear primary bribery offences under the new law: bribing another person, being bribed and bribing a foreign public official.

The New Corporate Offense and Defense. However, the new law does contain one radical change – the introduction of a new corporate criminal offense. Commercial organizations, including private companies and partnerships, now can be criminally liable if they fail to prevent bribery by persons associated with them. In the words of the new law: "A relevant commercial organization ("C") is guilty of an offence under this section if a person ("A") associated with C bribes another person intending – a) to obtain or retain business for C…; [or] b) to obtain or retain an advantage in the conduct of business for C."

If someone associated with a business commits an act of bribery, the only defense a business will have is if the business can show that it has adequate procedures in place to prevent bribery. Specifically "it is a defence for C to prove that C had in place adequate procedures designed to prevent persons associated with C from undertaking such conduct."

Private Equity's Exposure to the New Corporate Offense. The new legislation means that a company or firm can be criminally liable for the corporate offense as a result of bribery committed by someone associated with it. This has serious implications for private equity. For example, a private equity firm may be responsible for failing to prevent a bribery offense committed by a portfolio company, either as a result of its responsibility for managing the investments of its fund or as the result of a firm employee sitting on the board of the portfolio company.

This exposure is compounded by the law's broad territorial scope. English courts have jurisdiction over the corporate offense if it is committed by a body incorporated or formed under U.K. law (including a partnership) or any such body (wherever formed) that carries on business in the U.K., regardless of where the actual offense took place. There is therefore no need for the underlying offense to which corporate liability attaches to have any connection with the U.K.

What Should Those in the Private Equity Industry Be Doing? As set out above, a commercial organization's defense to the corporate bribery offense is to implement adequate procedures to prevent those associated with it from committing bribery. It is therefore imperative for those within the private equity industry to implement robust procedures to prevent bribery by themselves and their portfolio companies.

The Six General Principles. The U.K. government has issued guidance that provides a framework for the procedures that should be implemented based on the following six principles:

- Proportionate procedures: A requirement that the procedures a commercial organization implements to prevent bribery by those associated with it are proportionate to the bribery risks it faces and to the nature, scale and complexity of the commercial organization's activities.
- Top-level commitment: Top-level management must be committed to preventing bribery by those associated with that organization and foster a culture within the organization in which bribery is never acceptable.
- Risk assessment: A commercial organization must assess the nature and extent of its exposure to potential external and internal risk of bribery on its behalf and by persons associated with it. The assessment must be periodic, informed and documented.
- Due diligence: A commercial organization must apply due diligence procedures, taking a proportionate and risk-based approach, in respect of persons who perform or will perform services for or on behalf of the organization in order to mitigate identified bribery risks.
- Communicating and training: A commercial organization must seek to ensure its bribery prevention policies and procedures are embedded and understood throughout the organization through internal and external communication, including training, proportionate to the risks it faces.
- Monitoring and review: A commercial organization must monitor and review procedures designed to prevent bribery by persons associated with it and make improvements where necessary.

The Application of the General Principles to Private Equity. These general principles create specific requirements for all businesses, such as anti-bribery policies and training, top-level zero tolerance to bribery, assessing and auditing of bribery risks, and reviewing the effectiveness and suitability of policies. However, the more unique features of the private equity industry create particular best practices to which the firm should adhere. Some examples include:

– Private equity firms not only need to look after themselves, but also should ensure that all those in whom they invest implement adequate procedures to prevent bribery.

– Compliance with bribery laws, together with the efficacy of procedures in place for ensuring compliance with bribery laws, must be part of the due diligence for a potential investment and a criterion for assessing investment opportunities.

– Private equity firms should audit their existing investments afresh from an anti-bribery perspective and make necessary changes as soon as possible in order to reduce exposure to the new corporate bribery offense.

– Standard contracts, such as those with consultants engaged to assist with particular investments, should be reviewed to ensure they contain adequate provisions to protect against exposure to the new corporate bribery offense.

Annex A

New York

Employers should be aware of the New York FCRA, a more restrictive state law equivalent of the federal FCRA. In addition to requiring notice to and the advance consent of an applicant, the New York law gives an applicant the right to know if a "consumer report" or "investigative consumer report" was requested (and the name of the outside agency), even if no adverse action is taken.[40] Employers must notify applicants and employees of their rights under New York Correction Law Article 23-A if the employer will obtain an investigative consumer report.[41] The employer also must conspicuously post such notice in a place accessible to all employees.[42]

Employers are prohibited under New York law from making an adverse hiring or termination decision based on an individual's conviction record, unless there is a direct relationship between the prior criminal offense and the specific employment position; or where hiring or continuing to employ the individual would involve an unreasonable risk to property or safety or welfare of specific individuals or the general public.[43] Before determining that an individual's criminal record bars employment, employers must consider whether the offense will affect the person's ability to perform the job and how long ago the offense occurred, among other factors.[44] Employers also must consider any certificate of good conduct issued to the individual, which creates a rebuttable presumption of rehabilitation regarding the offenses to which it relates.[45] An employer also must provide an applicant, or an employee if the report contains criminal conviction information, with a copy of New York Correction Law Article 23-A.[46]

Further, employers in New York cannot ask about or take an adverse action based on any arrest unless the charges are still pending when the background check is conducted.[47]

California

In California, the Consumer Credit Reporting Agencies Act and the Investigative Consumer Reporting Agencies Act govern the consumer report and investigatory background check processes.

The CCRAA applies where the employer seeks a credit-related report from a consumer reporting agency.[48] Unlike the CCRAA and the FCRA, the ICRAA applies where an employer obtains a report, through any means (including through the employer's own use of public records), with information regarding an applicant's character, general reputation, personal characteristics and mode of living.[49]

Both California statutes require that the employer certify to the reporting agency that the employer is in legal compliance with all applicable rules.[50] Both statutes also require the employer to notify an applicant before obtaining a report, and the ICRAA further requires the applicant's written authorization prior to the interviews.[51] Both statutes also provide for the applicant to receive copies of any report within a designated period after the employer's receipt of the report.[52]

Moreover, under the ICRAA, if the employer plans to conduct its own public records investigation, the employer must provide the applicant copies of the public records, whether oral or written, within seven days after the employer's receipt of the information (unless the applicant waives receipt).[53] If the employer denies employment to the applicant based on information revealed through such an investigation, the employer must provide the records regardless of whether the applicant waived the right to receive the record.[54]

If an employer takes any adverse action against the applicant based on a credit-related report from an agency, the CCRAA requires the employer to provide written notice of the action to the applicant; the name, address and telephone number of the reporting agency which furnished the report; a written statement that the applicant has the right to dispute the report; and a statement that the applicant has the right to obtain a free copy of the report from the agency within sixty days of the notice.[55] The employer also must state that the applicant has the right to request a free report from any agency that compiles and maintains files on consumers on a nationwide basis.[56] Under the ICRAA, the employer must give notice of the adverse action and supply the applicant with the name and address of the agency.[57]

Like New York, California also restricts an employer's ability to inquire about criminal records. Employers cannot ask applicants to disclose information about arrests or detentions that did not result in a conviction or that resulted in referral to or participation in a diversion program.[58] However, an employer may inquire into arrests for which the employee is out on bail or pending trial.[59] California also restricts an employer's ability to use such arrest or detention as a factor in making employment decisions, including hiring, firing or promotions.[60] California permits employers to inquire into conviction records that have not been sealed, expunged or statutorily eradicated, including certain misdemeanor convictions.[61]

Maryland and Connecticut

Maryland and Connecticut join other states that prohibit even undertaking a credit background investigation, with narrow exceptions. Effective Oct. 1, 2011, employers face additional restrictions on their ability to review credit histories for hiring and retention purposes.[62] While this new legislation limits seeking such information, there are several exceptions which permit an employer to request and/or use the credit report, including where the employer is a financial institution, where the report is required under federal or state law or where the information is substantially job-related (for example, positions that involve handling money or confidential job duties).[63]

Messrs. Album and Gregory are partners in the Employee Benefits, Executive Compensation & ERISA Litigation Practice Center at Proskauer. They advise private equity firms and private equity executives on a range of compensation and related employment matters.

Endnotes

(1) King of Capital by Carey and Morris (2011).

(2) The case law makes clear that the position expressly referenced in the retainer letter is of critical importance. For example, in Koren Rogers Associates Inc. v. Standard Microsystems Corp., 914 N.Y.S.2d 29 (N.Y. App. Div. 2010), the search firm contracted with Standard to fill Standard's open position of "Director, Corporate Accounting" and provided several résumés to Standard, which decided to hire candidate A. Standard kept in touch with candidate B, however, who had been introduced by Koren Rogers and whom Standard did not previously know, and hired her nearly two years later as "Senior Director, Corporate Accounting and Assisting Controller." Standard was not required to pay Koren Rogers a placement fee for hiring candidate B because the contract did not address payment for candidates hired for positions other than "Director, Corporate Accounting," and once Standard hired candidate A for that position and paid Koren Rogers, its contract with the search firm terminated.

(3) Martin H. Bauman Assoc., Inc. v. H&M Int'l Transport, Inc., 567 N.Y.S.2d 404 (fee was 33 1/3% of the individual's first year total cash compensation plus out-of-pocket expenses); Koren Rogers Associates Inc. v. Standard Microsystems Corp, 914 N.Y.S.2d 29 (N.Y. App. Div. 2010) (fee was based on estimated starting base compensation plus a "target" bonus).

(4) In Nextel South Corp. v. R.A. Clark Consulting, Clark performed executive search services for Nextel, culminating in Nextel's hiring the executive. 596 S.E.2d 416 (Ga. Ct. App. 2004). The executive then resigned after five weeks, and Nextel refused to pay Clark's executive search fee. Nextel and Clark had no written agreement, but the court held that the search firm was entitled to recover under a special legal theory of "quantum meruit," which recognizes the value of work done by a party, even if no contract exists. Compare this result with the decision in Strauss Paper Co., Inc. v. RSA Executive Search, Inc., in which the search firm provided executive search services to Strauss Paper, culminating in the hiring of one of RSA's proposed candidates. 688 N.Y.S.2d 641 (N.Y. App. Div. 1999). Strauss Paper then terminated the new hire four months later. The written agreement between Strauss Paper and RSA specified that RSA would "guarantee" the new employee, would use its best efforts to replace the new hire if he resigned or was terminated within 180 days of hiring, and would not be paid until "placement completion." Since the candidate was terminated prior to the expiration of the 180-day period, no placement fee was owed to RSA.

(5) In JPMorgan Chase Bank, N.A. v. IDW Group, LLC, J.P. Morgan Chase & Co. sued the search firm IDW Group for poaching J.P. Morgan employees after it had engaged IDW to fill positions at J.P. Morgan. No. 08 Civ. 9116(PGG) 2009 WL 321222 (S.D.N.Y. Feb. 9, 2009). Although the case never reached adjudication on the merits, several of J.P. Morgan's claims survived summary judgment (including a claim that the search firm misused confidential information acquired during the search). IDW entered into several contracts with J.P. Morgan to provide executive search services, all of which contained provisions prohibiting IDW from soliciting J.P. Morgan employees or accepting overtures from J.P. Morgan employees to place them elsewhere, for a period of one year following the termination of the agreement or for a period of one year from the date of the last placement.

(6) In Mount Sinai Med. Ctr. of Greater Miami, Inc. v. Heidrick & Struggles, Inc., 188 Fed. Appendix 966 (11th Cir. 2006), the search firm contracted with its hospital client to present candidates for the position of hospital CEO and was then sued by its client after the candidate was hired and subsequently lost the hospital considerable sums. The court held that the search firm had fulfilled its obligation by providing its client with "executive summaries" of several candidates, whom the client then invited in for interviews at its sole discretion, and the search firm was not aware of the candidate's poor performance in the past, including the fact that the candidate's previous employer, a hospital in California, had lost millions of dollars during the final year of the candidate's term as CEO.

(7) For example, the candidate may be asked to represent and warrant that he or she: (1) is not currently and has not been the target of, witness in, or subpoenaed or deposed with respect to, any litigation or regulatory investigation; (2) has not been fined, sanctioned or otherwise found to have violated any securities-related regulations; and (3) has disclosed to the firm all material information regarding any legal or regulatory matter that might adversely affect the business or reputation of the firm.

(8) Fair Credit Reporting Act, 15 U.S.C. §1681h (e).

(9) 15 U.S.C. § 1681a(d)(1). Note that there are additional requirements for "investigative consumer reports," which are consumer reports containing information about an individual's character, general reputation, personal characteristics or mode of living that was obtained through personal interviews with neighbors, friends or associates or others. The distinguishing factor between the two is that a consumer report simply verifies factual information while an investigative consumer report includes interviews used to acquire additional information.

(10) 6/27/97 FTC Op. Ltr.; Congress also has indicated this in a Committee Report, H.R. Rep. No. 103-486, at 30 (1994).

(11) See generally 42 U.S.C. § 2000e et seq. (2000). The protection of Title VII applies only to individuals who qualify as employees under the statute. While a true partner is not considered an employee under Title VII, whether an individual is really a partner is subject to a number of factors, including whether the individual acts independently and participates in managing the organization or whether the individual is subject to the organization's control. See EEOC Compliance Manual, Threshold Issues (Aug. 9, 2009). As a result, it is important for employers to be aware that the title assigned to an individual may not extinguish the holder's rights under Title VII.

(12) The Equal Employment Opportunity Commission has held that upon a showing of adverse impact by an employee or applicant, the employer may justify its use of criminal background information as "job-related" and consistent with "business necessity" by showing that it considered the following three factors: (1) the nature and gravity of the offense; (2) the length of time since the conviction or completion of the sentence; and (3) the nature of the job held or sought. EEOC 1987 Policy Statement on the Issue of Conviction Records under Title VII of the Civil Rights Act.

(13) The 1934 Act defines an "associated person" of a broker-dealer as any partner, officer, director, branch manager or employee of the broker-dealer; any person performing similar functions; or any person controlling, controlled by, or under common control with, the broker-dealer.

(14) S.E.C. No-Action Letter to Brumberg, Mackey & Wall re: Denial of No-Action Request (May 17, 2010).

(15) The SEC has noted the limited scope of this issuer's exemption, and its position is that the so-called issuer's exemption does not apply to the personnel of a company who routinely engage in the business of effecting securities transactions for the company or related companies (such as general partners seeking investors in limited partnerships). The SEC's position is that the employees and other related persons of an issuer who assist in selling its securities may be brokers, especially if they are paid for selling these securities and have few other duties. See Division of Trading and Markets, U.S. Securities and Exchange Commission, Guide to Broker-Dealer Registration, found at http://www.sec.gov/divisions/marketreg/bdguide.htm (last visited August 26, 2011).

(16) The SEC rule applies both to firms that are registered as investment advisers under the Investment Advisers Act of 1940, as amended, and those that are currently exempt from such registration.

(17) AB 1743 also applies to the University of California's pension system. California Fair Political Practices Commission, "AB 1743 Fact Sheet – Placement Agents: Lobbyist Registration Requirements" (as revised January 2011). Local California employee retirement systems and the agencies that oversee them also may require lobbyist registration, but are not required to under AB 1743.

(18) In April 2011, New York Governor Andrew Cuomo ordered New York's Insurance Department to draft rules that would permanently ban third-party placement agents or other intermediaries from soliciting business with the Common Retirement Fund of the New York State and Local Retirement System. This ban would build on a similar but temporary ban imposed by the State Comptroller in 2009. See N.Y. Comp. Codes R. & Regs. Tit. 11 § 136-2.4(d) (2011). Governor Cuomo intends to ban third-party placement agents, lobbyists and elected officials from transacting any business with NYSLRS. Governor's Press Office, "Governor Cuomo Directs Insurance Department To Issue Permanent Regulations Banning Elected Officials, Lobbyists, and Placement Agents from Pension Fund Business, Eliminating 'Pay-To-Play'" (April 26, 2011). Current temporary regulations specifically exclude a private equity firm's employees from the ban, unless they are employed principally to influence a particular transaction or investment by NYSLRS. N.Y. Comp. Codes R. & Regs. Tit. 11 § 136-2.2(h) (2011). The permanent regulations have not been released for comment as of this writing. In addition to the Governor's order, similar legislation banning placement agents from transacting business with the Common Retirement Fund was introduced in May 2011. See A07909, 2011-2012 Leg., Reg. Sess. (N.Y. 2011).

In 2009, New York City's Comptroller imposed a similar prohibition on the use of third-party placement agents in transacting business with New York City pension systems. Although the Comptroller's office proposed relaxing the ban in February 2010, this proposal was rejected and the ban was reaffirmed. PR10-02-023, "Comptroller Liu Announces Major Reforms to Pension Fund Investments" (February 18, 2010); PR10-06-067, "Comptroller Liu Announces New Disclosure Requirements for Pension Fund Investment Process" (June 22, 2010); PR10-06-068, "Comptroller Liu To Implement New Disclosure Requirements for Pension Fund Investment Process at BERS" (June 22, 2010).

(19) N. Y. City Admin. Code tit. 3, ch. 2.; 51 RCNY ch. 1.

(20) The Comptroller of the City of New York is an elected official, and the Chief Investment Officer of the New York City pension system is a deputy comptroller, who is appointed by the Comptroller.

(21) See Westinghouse Credit Corp v. D'Urso, 278 F.3d 138 (2nd Cir. 2002) (discussing the purpose and case history of setoff under New York law). Rights of setoff may also be codified; for example, Section 151 of New York's Debtor and Creditor Law codifies the right to setoff and provides that a debtor may "set off and apply against any indebtedness…of such creditor to any debtor, any amount owing from such debtor to such creditor."

(22) Id.

(23) Willett v. Lincolnshire Mgt. Inc., 302 A.D.2d 271 (1st Dept. 2003)

(24) See Westinghouse Credit Corp., supra note 21.

(25) For example, New York State Labor Law Section 193 expressly prohibits an employer from making any deductions from an employee's wages, other than with respect to very narrow categories expressly authorized by law (e.g., FICA, Social Security, insurance premiums, pension or health and welfare benefits). California and other states have similar wage protection laws.

(26) Section 409A is a complex and highly technical tax code provision that is well beyond the scope of this article. For our purposes, it is sufficient to note that a violation of Section 409A generally will result in a 20% excise tax plus accelerated income tax inclusion and interest, all imposed on the payee/employee (although the payor/employer also may be subject to penalties for failing to comply with separate withholding and reporting obligations imposed on the employer).

(27) Section 409A does permit limited offsets against deferred compensation where the debt is incurred in the ordinary course of the employment relationship but only to the extent that the entire offset in any year does not exceed $5,000.

(28) Section 304 of Sarbanes-Oxley (15 U.S.C. Sec. 7243 (2002) ("SOX"); see also the clawback provisions of TARP (EESA Sec. 111(b)(3)(B), as amended by ARRA Sec. 7001).

(29) Section 954 of Dodd-Frank is similar to Section 304 of SOX, but differs in several important aspects. Thus, for example, Section 304 only goes back one year instead of three and applies only to a company's CEO and CFO, and not to all current and former executive officers within the relevant time period, as provided under Dodd-Frank. Further, SOX requires an allegation of misconduct to trigger the clawback provision, whereas in the Dodd-Frank context no such allegation is necessary. Under Dodd-Frank, if a restatement is necessary due to material noncompliance with applicable accounting principles, the clawback applies, regardless of whether an allegation of misconduct has been made. The SEC currently plans to finalize regulations on Section 954 of Dodd-Frank between January and June 2012. The SEC's updated timeline can be found on its website at http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml.

(30) This doctrine has been adopted in certain states, including New York, and generally holds that where an employee chooses to resign and violates a post-employment non-compete containing a forfeiture clause, such employee may be treated as having waived his post-employment compensation, and the non-compete covenant is not subject to the strict scrutiny usually applied by courts. The employee choice doctrine is based on the premise that a resigning employee can choose between either preserving compensation by refraining from competition, or forfeiting such payments by choosing to compete with a former employer. See Morris v. Schroder Capital Management, 7 N.Y. 3d 616 (2006).

(31) The repaid amount is excluded from the employee's wages for the year of repayment and is not reported on the employee's form W-2. This is the case regardless of whether repayment is held back in the form of other compensation or the employee pays the amount back directly to the employer by check. See Rev. Rul. 79-311, 1979-2 C.B. 25. With respect to payroll taxes, the employer reports the overpayment of both the employee's and employer's share of such taxes on an amended return for the period (Form 941-X) and generally receives a credit adjustment for such overpayment. 26 C.F.R. 31.6413(a)-2(b)(2)(i).

(32) Also, if the clawback payment is due with respect to a capital investment, the repayment may generate a capital loss, which may be of limited value unless the employee has additional capital gains to offset in the year of repayment or in future years.

(33) See Rev. Rul. 67-48, 1967-1 CB 50.

(34) Rev. Rul. 67-437, 1967-2 CB 296.

(35) See Dominion Resources, Inc. v. US, 219 F.3d. 359 (4th Cir. 2000); and Pennzoil-Quaker State Co. v. U.S., 62 Fed. Cl. 689 (2004) (overruled, but on unrelated grounds).

(36) For an excellent summary of the issues surrounding the taxation of clawbacks, see Barker & O'Brien, "Taxing Clawbacks: Theory and Practice," Tax Notes (October 25, 2010).

(37) A threshold consideration for a firm is whether there are any legal or regulatory bars to making loans to executives, fund managers or employees more generally. Under Section 402 of SOX (15 U.S.C. § 78m(k)), loans cannot be made by public companies to "executive officers," or the equivalent thereof. The term "executive officer" is not defined under Section 402, but separate regulations previously issued under the Exchange Act define executive officers for other purposes generally as any president, vice president in charge of a principal business unit, division or function, and any other officer who performs a policy making function. See 17 C.F.R. § 240.3b-7.

(38) PLR 200040004 (Oct. 6, 2000).

(39) Rev. Rul. 68-337, 1968-1 C.B. 417 (advances repayable out of future earnings for services); Rev. Rul. 69-465, 1969-2 C.B. 27 (advances repayable out of future commissions of insurance salesmen); but see IRS Counsel Memorandum 200935029 (8/28/09) (salary advances taxable when received).

(40) See N.Y. Gen. Bus. Law § 380-b (McKinney 2011).

(41) See N.Y. Gen. Bus. Law § 380-c (McKinney 2011).

(42) See N.Y. Lab. Law. § 201-f (McKinney 2011).

(43) See N.Y. Exec. Law § 296(15) (McKinney 2011); N.Y. Corr. Law § 753.

(44) Id.

(45) N.Y. Corr. Law § 753.

(46) See N.Y. Lab. Law. § 201-f.

(47) See N.Y. Exec. Law § 296(16) (McKinney 2011).

(48) See Cal. Civ. Code § 1785.3(c) (West 2011) (defining "consumer credit report").

(49) See id. § 1786.2(c) (defining "investigative consumer report" as a report containing the relevant information "obtained through any means"); id. § 1786.53(a).

(50) Cal. Civ. Code. §§ 1785.14(a), 1786.16(a)(4).

(51) Cal. Civ. Code §§ 1785.20.5(a), 1786.16(a)(2)(B), 1786.16(a)(2)(C).

(52) Id. § 1786.16(a)(5); 1785.20.5(a).

(53) Id. § 1786.53(b)(1), (2).

(54) Id. § 1786.53(b)(4).

(55) Cal. Civ. Code § 1785.20(a).

(56) Cal. Civ. Code § 1785.20(a)(4)(A).

(57) Cal. Civ. Code § 1786.40.

(58) Cal. Lab. Code § 432.7 (West 2011); Cal. Code Regs., tit. 2, § 7287.4(d) (West 2011).

(59) Id. § 7287.4(a)-(c).

(60) See id.

(61) See Cal. Lab. Code § 432.7; Cal Code Regs. tit. 2, § 7287.4. Note that an employer may not request information concerning convictions for certain marijuana offenses that are more than two years old. Cal. Lab. Code § 432.8 (West 2011).

(62) See Md. Code Ann., Lab. & Empl. § 3-711 (West 2011); Conn. Pub. Acts, 11-223 (Reg. 2011 Sess.).

(63) Md. Code Ann., Lab. & Empl. § 3-711; Conn. Pub. Acts, 11-223 (Reg. 2011 Sess.).