

BROKERAGE RAIDING

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Hot Trends in Securities Arbitrations

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INTRODUCTION

The branch office manager calls management on Friday afternoon tendering his resignation and announcing that several of the better producers in the branch have already resigned, all to join the same competitor.

A similar set of facts: the branch office manager calls the home office again on Friday afternoon and states that most of his producers have just walked out the door to join a competitor. He then requests that someone from the region or the home office come to the branch to help him show the flag.

Both of these fact patterns may spell out a potential “raiding” claim against the competitor. These and other similar scenarios are all too common within the financial services industry and typically lead to serious losses of valuable business, goodwill and human capital.

RECENT LARGE RAIDING AWARDS

I. RODMAN & RENSHAW V. TUCKER ANTHONY & SUTRO

In February 2002, the New York investment banking firm of Rodman & Renshaw received a \$900,000 arbitration award against the Boston-based securities firm Tucker Anthony & Sutro, now part of RBC Dain Rauscher. See Rodman & Renshaw, Inc. v. Tucker Anthony, Inc., NYSE Arb. No. 1997-006562 (Feb. 6, 2002). By a 2 to 1 decision, a three member New York Stock Exchange arbitration panel found that Tucker, along with some of its top executives and producers, improperly lured away Rodman’s bank services practice and interfered in Rodman’s client relationships as part of a 1997 defection by some Rodman employees.

According to an industry periodical regarding the raid:

In 1996, Tucker's Chicago branch manager and an Anthony broker put a deal together to raid Rodman. At the time, Rodman was experiencing severe financial problems. It had recently reorganized and had lost money for several years. The targeted team, which specialized in bank and thrift stocks, seemed ripe for the plucking. Tucker offered Rodman's Chicago branch manager a written deal that included a bonus for each Rodman employee he could bring with him. Under the deal, the manager had a month to persuade his colleagues to join him, contact clients and transfer secretly copied files. All the while he was negotiating with Rodman to stay with the firm. One of the employees testified that the team "pulled every new-account form out of there, made a copy of it . . . put it in a three-ring binder and anything else in the book folder that I thought was important." The documents taken included account statements and agreements, trading authorizations, instructions for wire transfers, authorizations for writing checks and more. In addition, weeks before the move, the Rodman employees called clients and told them that, once the team moved, Rodman would no longer be able to provide the same services. In April of 1997, the Rodman team, six brokers and four other employees, moved to Tucker. Although 30 brokers remained at Rodman, without the bank services group, the bank could not compete in the highly specialized market. Rodman filed for bankruptcy a year later when its parent, Mexico's Abaco Grupo Financiero SA, ended financial support.

See Bruce Kelly, *A Well-laid Raid Yields Big Sting*, Investment News, March 4, 2002, at 1.

According to the NYSE Arbitration Award:

In June 1997, Rodman instituted an NYSE arbitration action against Tucker and the 10 former employees alleging violations of the Illinois Trade Secret Act, conspiracy to commit breach of fiduciary duties, tortious interference with business relations, conversion, and unjust enrichment. Respondents counterclaimed for Rodman's alleged failure to keep various commitments. The panel denied the respondents's counterclaim and concluded that Tucker improperly encouraged Rodman's employees to contact clients, make copies of private client files and conduct sham negotiations to stay at Rodman so that the banking services team could have additional time to plot their exit while still on Rodman's payroll. Of the \$900,000 award, Tucker was apportioned \$200,000 for punitive damages and \$200,000 for compensatory damages. Rodman's branch manager was apportioned \$125,000 in compensatory damages and \$250,000 in punitive damages. The other former Rodman employees were apportioned compensatory damages between \$60,000 and \$1,000.

II. JOHN G. KINNARD V. DAIN RAUSCHER

In John G. Kinnard & Co. Dain Rauscher, Inc., NASD Arbitration No. 98-00854 (Dec. 10, 1999), John G. Kinnard & Co., a Minneapolis based broker-dealer, received an arbitration award in excess of \$16.5 million against Dain Rauscher based on Dain Rauscher's raid on Kinnard's St. Louis Park, Minnesota branch office.

According to court filings:

In 1997, Dain hired the branch manager of Kinnard's successful St. Louis Park office. Prior to the branch manager's voluntary termination, he had been working with Dain to plan for the opening of a new Dain branch office in North Oaks, Minnesota, in which he would be the manager. Upon the branch manager's departure, Kinnard appointed an interim manager for the St. Louis Park office. However, almost immediately after accepting the position, the interim manager, together with several of the Kinnard employees he managed, began meeting with Dain to discuss employment. In January and February of 1998, seven licensed employees of Kinnard's St. Louis Park office resigned and joined Dain's North Oaks office. Some of the former Kinnard employees breached non-compete clauses in their Kinnard employment contracts and captured roughly 52% of the productive capacity of Kinnard's St. Louis Park office. In March of 1998, Dain hired all four of Kinnard's Thief River Falls, Minnesota branch office and two from Kinnard's Minneapolis branch office. Dain hired from Kinnard a total of 18 brokers (including three Branch Office Managers and a National Sales Manager), who combined were responsible for approximately 20% of Kinnard's gross retail commission revenues.

According to the NASD arbitration award:

Kinnard filed its statement of claim in March 1998, alleging claims including violation of Rule 2110 of the NASD Fair Practices Rules; breach of contract; tortious interference with contract and with prospective economic advantage; breach of duty of loyalty/fiduciary duty; conversion; libel and defamation; unfair competition; injunctive relief; and punitive damages. The above award included \$7,000,000 in punitive damages against respondent Dain.

Dain and Kinnard eventually settled the dispute for \$13.3 million while confirmation of the award was on appeal by Dain in Minnesota State court. See Dain Rauscher Press Release: *Dain Rauscher, Stockwalk.com Group, Inc. Settle Arbitration Case*, September 27, 2000.

III. PRINCIPAL FINANCIAL SEC., INC. AND EVEREN CAPITAL CORP. V. RAYMOND JAMES & ASSOCS, INC.

In Principal Financial Sec., Inc. and Everen Capital Corp. v. Raymond James & Assocs., Inc., NYSE Arbitration No. 1998-007021 (Jan 10, 2000), claimant Everen was awarded over \$2 million in compensatory damages, \$2.1 million in punitive damages, and \$650,000.00 in attorneys' fees, based on Raymond James' raid on Principal's Des Moines, Iowa office.

According to Everen's statement of claim:

In 1997, Principal Mutual Life Insurance sought to sell its broker-dealer subsidiary, Principal Financial Securities. Principal hired a financial advisor for the sale which provided confidential data to several broker-dealers who were likely acquirers. To receive the confidential information, potential purchasers had to agree to limit their recruiting activities, and restrict both use of and access to the information. Raymond James contacted Principal's financial advisor and requested additional confidential information. Principal complied and provided information revealing the profitability and market share of each Principal branch office. Raymond James did not purchase Principal and ultimately Everen Capital Corp. did.

Immediately after the sale to Everen, Raymond James contacted two of Principal's Des Moines, Iowa managers and flew them to Florida where Raymond James executives took them to a, they urged clients to prepare to move their accounts, stole original customer hockey game, out to dinner, and met with them the next morning as part of their formal recruiting interviews. During the meeting, production of the brokers, their sales assistants and other employees was discussed, as well as Everen's pay scale, and the productivity of other former Principal offices in Iowa. The managers were offered positions at Raymond James and offered bonuses for each broker that they could bring with them.

Upon their return to Iowa, the two managers set out to recruit other Principal brokers. In all, Raymond James recruited 16 branch managers and 63 brokers, both Principal regional managers, the firm's general counsel, and the chief compliance officer. Before the brokers tendered their resignations account files, and even interviewed prospective Raymond James employees in Principal's offices.

According to the NYSE arbitration award:

In addition to rendering the monetary award, the arbitration panel referred the lead defectors to the NYSE Enforcement Department for disciplinary action.

IV. EVEREN SECURITIES, INC. V. A.G. EDWARDS & SON, INC.

In Everen Securities, Inc. v. A.G. Edwards & Son, Inc., NYSE Arbitration No. 1996-006223 (Nov. 18, 1997) and 719 N.E.2d 312 (Ill. Ct. App. 1999), Everen brought an arbitration claim against A.G. Edwards and two former brokers alleging breach of fiduciary duty; breach of contract; aiding and abetting breach of fiduciary duty; conspiracy; misappropriation of trade secrets; and unfair competition.

According to the Illinois Court of Appeals opinion:

The arbitration claim arose from A.G. Edwards' hiring of two of the three brokers from Everen's Galesburg, Illinois office, together with two support personnel. Then, with the personnel hired from Everen, A.G. Edwards opened a new office in Galesburg. The brokers hired from Everen were subject to non-compete agreements. A.G. Edwards used the former Everen employees' access to Everen's confidential and proprietary customer information, and the departing brokers were paid substantial monetary incentives by A.G. Edwards. The former Everen brokers solicited their Everen customers in violation of their non-compete agreements. Everen sought temporary injunctive relief in Illinois State court to prohibit the two former employees from soliciting clients of Everen and to seek the return of customer information documents which Everen argued were trade secrets. The court granted the injunction as to the customer documents unless the defendants received authorization from the clients.

Without making specific findings of fact or conclusions of law, the arbitration panel awarded Everen \$1.1 million, which was affirmed by both an Illinois trial court and the Illinois Court of Appeals.

IV. EVEREN SECURITIES, INC. V. A.G. EDWARDS & SON, INC.

According to the NYSE arbitration award:

In Kemper Securities, Inc. v. Dean Witter Reynolds, Inc., NYSE Docket No. 96-5567 (Feb. 5, 1998), claimant Kemper Securities alleged that Dean Witter raided four branch offices in Illinois. Kemper alleged that Dean Witter lured away every Kemper employee in the four offices, paid them more than \$4,500,000.00 and induced them to bring documents and information necessary to conduct business under the Dean Witter name. Kemper alleged that its customer information removed from the Kemper offices constituted trade secrets, information protected by the Illinois Trade Secret Act; the individual respondents' misconduct and misappropriation of customer information was a breach of trust and fiduciary duty; Dean Witter aided and abetted the brokers' breach of their duties; and Dean Witter's illegal taking of Kemper's customer files and customer information constituted unfair competition. The NYSE arbitration panel awarded Kemper \$6,000,000.00 in compensatory damages, \$550,000.00 in attorneys' fees, and denied the claims against the individual respondents.

LEGAL BASIS FOR RAIDING CLAIMS

I. RIGHTS AND DUTIES OF EMPLOYERS AND EMPLOYEES

A. Employer's Rights

When a competitor intentionally recruits key employees, what are the employer's rights without an enforceable non-compete agreement?

Courts generally have tried to strike a balance between protecting the employer from unfair competition or trade secrets misappropriation, and protecting the employee's right to freely seek employment in a competitive marketplace, without undue restriction. As a result, the outcome of these cases depends upon the specific facts in each case, the evidence presented by the parties, and the relative hardship the parties are likely to suffer if the relief sought is granted or denied.

An employee has a right to prepare to enter into competition with his employer while he is still employed. Rehabilitation Specialists, Inc. v. Koering, 404 N.W.2d 301, 304 (Minn. Ct. App. 1987); see also Sanitary Farm Dairies v. Wolf, 112 N.W.2d 42, 48-9 (Minn. 1961). This right, however, must be balanced against the employee's duty of loyalty to his employer. Whether an employee's actions rise beyond mere preparation to a breach of his duty of loyalty is a question of fact to be determined based on the circumstances of each case. Rehabilitation Specialists, Inc., 404 N.W.2d at 305.

If an employee does breach his duty of loyalty, he may be charged with unfair competition. Id. at 306. Unfair competition is not itself a cause of action under Minnesota law, rather, it is usually brought in reference to two specific business torts: (1) tortious interference with economic relations; and (2) improper use of trade secrets. United Wild Rice, Inc. v. Nelson, 313 N.W.2d 628, 632 (Minn. 1982). An employee's solicitation of customers or co-workers may constitute tortious interference with economic relations. An employee's misappropriation of confidential business information for use in his new enterprise may constitute an improper use of trade secrets.

B. Employee's Duty to Employer

Even in the absence of an employment agreement, "employees have a common-law duty not to wrongfully use confidential information or trade secrets obtained from an employer." Jostens, Inc. v. National Computer Systems, 318 N.W.2d 691, 701 (Minn. 1982). Every employee, and particularly those charged with management responsibilities, owes a duty of loyalty to his employer. Lamdin v. Broadway Surface Advertising Corp., 272 N.Y. 133, 5 N.E.2d 66, 67 (1936); Rehabilitation Specialists, Inc. v. Koering, 404 N.W.2d 301 (Minn. Ct. App. 1987). Simply put, an employee is not permitted to "feather his own nest at the expense of his employer while he is still on the payroll." Sanitary Farm Dairies, Inc. v. Wolf, 112 N.W.2d 42, 48 (1961). Such duties exist by law, independent of any contractual arrangements. Duane Jones Co. v. Burke, 306 N.Y. 172, 117 N.E.2d 237, 246 (1954); S&K Sales Co. v. Nike, Inc., 816 F.2d 843 (2d Cir. 1987); Frederick Chusid & Co. v. Marshall Leeman & Co., 326 F. Supp. 1043 (S.D.N.Y. 1971).

An employee breaches the fiduciary duty of loyalty to the employer when he or she solicits the employer's customers during the period of employment and when he or she uses its confidential information for competitive purposes. Bellboy Seafood Corp. v. Nathanson, 410 N.W.2d 349, 353 (Minn. Ct. App. 1987). Former employees may compete with their former employers absent a contractual restrictive covenant, provided there was not demonstrable business activity *before* termination of employment. Everen Securities, Inc. v. A.G. Edwards & Sons, Inc., 719 N.E.2d 312 (Ill. Ct. App. 1999); *see also* Rehabilitation Specialists, Inc., 404 N.W.2d at 304. In addition to refraining from soliciting a present employer's customer, an employee may not discourage any customer from doing business with his employer. He must instead continue to act "solely for [his employer's benefit] on all matters connected with his employment." Jet Courier Service, Inc. v. Mulei, 771 P.2d 486, 498 (Colo. 1989); *see also* Maryland Metals, Inc. v. Metzner, 382 A.2d 564, 568 (Md. Ct. App. 1978) (employee must refrain from directly competing with his employer for customers, and must continue to exert his best efforts on behalf of employer while employed). Furthermore, an employee should be candid with his employer about his plans to start a competing business; however, he is not required to disclose the details of his plan. Maryland Metals, Inc., 382 A.2d at 569.

The employer may not violate his duty of loyalty by soliciting co-employees to leave with him. Impermissible solicitation of co-workers, however, is a matter of degree and various factors may be taken into account such as "the nature of the employment relationship, the impact or potential impact of the employee's actions on the employer's operations, and the extent of any benefits promised or inducements made to co-workers to obtain their services for the new competing enterprise." Jet Courier Service, Inc., 771 P.2d at 497.

Permissible actions that an employee may take prior to termination in some states may include purchasing a rival business and advising customers that he will be leaving his current employment. *Id.* at 494; *see also* Sanitary Farm Dairies, Inc., 112 N.W.2d at 49. These actions, however, may not be universally accepted. An employee must use caution when advising customers that he will be starting his own operation, and decline to participate in any attempt by the customer to negotiate future business. Rehabilitation Specialists, Inc., 404 N.W.2d at 305. Employees have been held liability for advantages secured by them, after termination of their employment, as a result of opportunities gained by reason of their employment relationship. Duane Jones Co. v. Burke, 306 N.Y. 172, 117 N.E.2d 237, 246 (1954)

One who engages in tortious conduct may not be able to raise alleged dissatisfaction with one's employer as a defense or justification. In Duane Jones Co. v. Burke, *supra*, the defendants, who had breached their fiduciary duties to the plaintiff corporation, sought to justify their actions by raising individual concerns about that corporation. The evidence at the trial revealed that Duane Jones, the president of the plaintiff corporation, had been guilty of certain "behavior lapses" at his office, at business functions and during interviews with actual and prospective customers. As a result of those occasions of misbehavior, defendants described the working conditions as "intolerable." Duane Jones Co., 306 N.Y. at 241. The court found the arguments irrelevant as a matter of law.

C. Trade Secrets

Where a former employee is not subject to an enforceable non-compete or confidentiality contract, upon termination of an employee's employment, the employer is required to establish the existence of genuine trade secrets, and the misappropriation of such secrets by the employee or competitor, in order to sustain a misappropriation of trade secrets claim or to seek and receive an injunction against the former employee or competitor.

i. Uniform Trade Secret Act

It is generally recognized that at the termination of employment, an employee may not take with him confidential, particularized plans or processes developed by his employer and disclosed to him or her while the employer-employee relationship existed, which are unknown to others in the industry, and which give the employer an advantage over his competitors. Such confidential information, or *trade secrets*, includes "information, including a formula, pattern, compilation, program, device, method, technique, or process, that:

- (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and
- (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

Uniform Trade Secret Act, Minn. Stat. § 325C.01, subd. 5. (defining "trade secrets"). The existence of a trade secret is not negated merely because an employee or other person has acquired the trade secret without express or specific notice that it is a trade secret if, under all the circumstances, the employee or other person knows or has reason to know that the owner intends or expects the secrecy of the type of information comprising the trade secret to be maintained. *Id.*; see also Delta Filter Corporation v. Morin, 108 A.D.2d 991, 485 N.Y.S.2d 143 (1985); Courtesy Temporary Service v. Camacho, 222 Cal. App. 3d 1278, 272 Cal. Rptr. 352 (Ct. App. 1990); Cherne Industrial, Inc. v. Grounds & Assoc., 278 N.W.2d 610, 645 (Minn. 1979).

To prevail in court, the employer must identify specific trade secrets which are in the former employee's possession and which are at risk. General allegations that the former employee has pricing information, knowledge of distributors or customers, sales information, cost information, knowledge of business strategy or other internal information is usually not sufficient. Such information, falls into the category of general information. Compare Cincinnati Tool Steel Co. v. Breed, 482 N.E.2d 170, (Ill. Ct. App. 1985) (fact that former employee might be able to recollect pricing information that could potentially be used to the plaintiff's detriment while working for competitor is too conjectural to establish a trade secret) with PepsiCo., Inc. v. Redmond, 54 F.2d 1262 (7th Cir. 1995) (injunction upheld where former key employee possessed actual documents containing corporate operating plan and pricing architecture).

ii. General Skills and Knowledge Acquired by Employee

An employee is generally free to take general skills and knowledge acquired during his or her tenure with his or her former employer. See Prebon Yamme (USA) Inc. v. Cantor Fitzgerald, LP, No. 134959/94 (Sup. Ct. N.Y. Co. 1995) (absent some wrongdoing, defendant's use of his knowledge of the plaintiff's inter-bank brokerage operations did not constitute misappropriation of a trade secret). However, some courts have held that an employer has a protectable interest in an employee's knowledge or relationships which are unique or extraordinary and which were gained in the employment. Several cases have focused on the unique relationship that the employee has built with the employer's clients. Some courts have held that the "unique" relationship that an employee develops with the employer's clients is an interest of the employer that an employer can protect from exploitation by the employee. Leon M. Reimer & Co. v. Cipolla, 929 F. Supp. 154, 158 (S.D.N.Y. 1996) (employer "entitled reasonably to protect relationships developed at [the employer's] expense."); Neveaux v. Webcraft Technologies, Inc., 921 F. Supp. 1568, 1571 (E.D. Mich. 1996) ("New Jersey courts expressly 'recognize as legitimate the employer's interest in protecting . . . customer relations'"). An employee's knowledge or relationships may be unique or extraordinary if they are of such nature as to make his or her replacement impossible or that their loss would cause the employer irreparable injury. Maltby v. Harlow Meyer Savage, Inc., 166 Misc. 2d 481, 633 N.Y.S.2d 926 (Sup. Ct. N.Y. Co. 1995) (broker had unique relationship with customers that had been developed while employed by the plaintiff, and partially at plaintiff's expense).

iii. Customer Information

An issue in raiding cases often involves the status of a broker's customer list. Some courts have held that the names and addresses of a broker's clients are not "confidential customer lists" or trade secrets in the brokerage industry. Merrill Lynch v. E.F. Hutton & Co., 403 F. Supp. 336, 340-41 (E.D. Mich. 1975) (court determined that certain "option ledgers" containing client information concerning the kind and class of option, starting price, expiration date and profit and loss data, were not "trade secrets," finding that evidence that "removal of records and solicitation of clients is consistent with industry practice" and that "[Merrill Lynch] has, in fact, sanctioned such action" was sufficient to preclude the injunctive relief sought by Merrill Lynch); Merrill Lynch v. Bishop, 839 F. Supp. 68 (D. Me. 1993); Leo Silfen, Inc. v. Creame, 29 N.Y.2d 387, 392 (1977) ("where the employer's past or prospective customers' names are readily ascertainable from sources outside its business, trade secret protection will not attach and their solicitation by the employee will not be enjoined."). An employer's customer list does not qualify as a trade secret protectible against unfair post-employment competition by a former employee where the employer does its marketing through independent representatives who develop their own customer lists and are not bound by a confidentiality agreement. Crown Holding Corp. v. Larson, 440 N.W.2d 373, 375 (Minn. Ct. App. 1985). Client account numbers may also be readily ascertainable by proper means because this information is easily obtained from the clients themselves. See Steenhoven v. College Life Ins. Co. of Am., 458 N.E.2d 661, 666-67 (Ind. Ct. App. 1984).

However, other courts have held that a where an employer has shown that it expended considerable time, money or effort in developing a list the list is a protectible interest. Leo Silfen, Inc. v. Cream, 29 N.Y.2d 387, 393, 328 N.Y.S.2d 423, 427 (1972) (where customers are not known in the trade or are discoverable only by extraordinary efforts, court have not hesitated to protect customer lists and files as trade secrets, especially where the customers' patronage has been secured by years of effort and advertising effected by the expenditure of substantial time and money); McLaughlin, Piven, Vogel, Inc. v. W.J. Nolan, 114 A.D.2d 165, 498 N.Y.S.2d 146 (2d Dep't 1986) (holding that the customer lists of financial services company met the standard for trade secrets); Merrill Lynch v. Kramer, 816 F. Supp. 1242, 1246 (N.D. Ohio 1992) ("Even absent a specific contractual provision, Merrill Lynch's customer list is entitled to trade secret protection under Ohio law."); IDS Life Insurance Co. v. Sun America, Inc., 958 F. Supp 1258, 1278 (N.D. Ill. 1997) (where plaintiffs paid millions of dollars to develop confidential customer information and took reasonable steps to ensure the secrecy of the information by requiring employees sign confidentiality agreements, such information was a trade secret); Hagen v. Burmeister & Assoc., No. C8-98-864, 1999 Minn. Ct. App. Lexis 85, at *8 (January 26, 1999) (parties agreed employee's misappropriation of confidential customer list violated Minnesota Trade Secret Act).

More than an intention to keep the information secret is required on the part of the employer – the employer “is required to show that it had manifested that intention by making some effort to keep the information secret.” Electro-Craft Corp. v. Controlled Motion, Inc., 332 N.W.2d 890, 901 (Minn. 1983).

Trade secret protection . . . depends upon continuing course of conduct by the employer, a course of conduct which creates a confidential relationship. This relationship, in turn, creates a reciprocal duty in the employee to treat the information as confidential insofar as the employer has so treated it.

Id. The Electro-Craft court found that an employer failed reasonably to try to keep certain proprietary information secret, despite having screened its handbook and publications for confidential information, and having required its employees to sign confidentiality agreements. The employer's physical security measures did not demonstrate the necessary effort to maintain secrecy. Id. at 901-02. The employer's plant had seven unlocked entrances without signs warning of limited access. Discarded drawings and plans containing the alleged trade secrets were simply thrown away, not destroyed. Important documents were not kept in a central or locked location. Id.; see also Gordon Employment, Inc. v. Jewell, 356 N.W.2d 738, 741 (Minn. Ct. App. 1984) (trade secret protection for a customer list denied when the employer failed to physically secure the list -- it kept the list in an unlocked file).

II. CAUSES OF ACTION FOR RAIDING

A. NASD Conduct Rules

The Conduct Rules of the NASD (formerly known as the Fair Practice Rules) provide: “A member, in the conduct of his business, *shall observe high standards of commercial honor and just and equitable principles of trade.*” NASD Manual, Conduct Rules, Rule 2110 (emphasis added).¹ The NASD rules serve the statutory objective of protecting the public from unethical transactions, providing supervision of the NASD members, and promoting public confidence in the integrity of self-regulation. Cariveau v. Halferty, 83 Cal. App. 4th 126, 133-34 (2000) (“the NASD rules are a valid source of public policy and provide a guiding bridle for an unruly steed.”)

Most exchanges require applicants for membership, as a prerequisite to admission, to sign the constitution of the exchange or an agreement to be bound by its provisions. These conditions are, therefore, binding on the members, and constitute virtually a body of law by which the members are governed in their dealings with the exchange and with each other. 1 C. H. Meyer, The Law of Stock Brokers and Stock Exchanges § 7 (1931).

Although courts have not recognized a private right of action by a *customer* for a member’s violation of the industry Conduct Rules, courts have found that the NASD rules form a contract between NASD member firms which can be specifically enforced. See Offerman & Co. v. Hamilton Investments, Inc., 1994 U.S. Dist Lexis 21461, *8 (E.D. Wis. May 4, 1994) (In upholding \$225,000.00 NASD raiding claim award, stated “Courts have generally stated that exchange rules constitute a ‘contract’ between the members of an exchange which can be specifically enforced.”); see also Coudert v. Paine Webber Jackson & Curtis, 705 F.2d 78, 81 (2d Cir. 1983); Creative Securities Corp. v. Bear Stearns & Co., 671 F. Supp. 961, 966 n.7 (S.D.N.Y. 1987); Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 769-70 (S.D.N.Y. 1968). Therefore, when one member wrongfully solicits the employees of another member, the later arguably may enforce the public policy and purposes behind the NASD Rules of Conduct and receive an award for unlawful trade practices.

The purposes of the Rules of Conduct are designed primarily to protect the consumer-investor. The Rules are generally designed to protect industry participants only insofar as that protection works to benefit the consumer-investor. Long-term relationships between a

¹ The Constitution of the New York Stock Exchange, Inc. similarly includes in its statement of the purposes and objectives of that organization: “to maintain high standards of commercial honor and integrity among its members, allied members and member organizations; to promote and inculcate just and equitable principles of trade and business.” Constitution of New York Stock Exchange, Art. I, Sec. 2. Likewise, the Constitution of the American Stock Exchange, Inc. sets forth as one of its purposes: “to promote and maintain just and equitable principles of trade and business.” Constitution of American Stock Exchange, Inc., Art. I, Sec. 2.

broker and a member-firm arguably contribute to better customer service. See S.E.C. Executive Summary: Report of the Committee on Compensation Practices, May 1994. Through long term relationships with their brokers, clients learn more about the products and services offered by member firms, and about the investment philosophy of the individual broker assigned to their accounts. Up front bonuses and accelerated commission pay-outs offered by a firm to recruit brokers can lead to conflicts of interest between broker and client. When firms offer lucrative compensation to induce brokers into switching firms, ultimately such conduct can harm customers and lead to inappropriate investment advice. See S.E.C. Chairman Harvey Levitt, *The State of the Brokerage Profession*, April 20, 1998.

B. Breach of Contract

i. Covenants Not-to-Compete

A covenant not-to-compete is a contractual provision which seeks to prevent an employee from engaging in competitive activity which would damage the employer's business. The provision typically prohibits the employee from working for or in association with a direct competitor of the employer or from soliciting the employer's customers. In addition, such provisions often seek to prohibit the employee from using or disseminating confidential information and from soliciting other employees to leave the employer.

In general, covenants which unreasonably limit competition or restrict the ability of individuals to find employment are disfavored by the courts. The primary factors most courts consider in analyzing the enforceability of a covenant not-to-compete are: (1) whether the covenant is supported by consideration, (2) the scope of the prohibited activities, (3) the geographic area in which competition is prohibited, (4) the duration of the restriction, and (5) whether the employer has a legitimate "protectible interest" at stake. See *Alside, Inc. v. Larson*, 220 N.W.2d 274 (Minn. 1974) (upholding two year restriction on right of former employee to solicit former employer's customers within a six-county area).

ii. Intra-Competitor No Poach Agreements

While the case law discussing employer-employee non-competition agreements is well developed, there are few cases discussing employer-employer non-competition agreements. These employer-employer agreements, often referred to as "no-poach," "no-hire" or "no-switching" agreements, prohibit signatories from soliciting or "pirating" employees of other signatories or from hiring former employees of other signatories for a specified period of time. These arrangements may have implications under federal antitrust laws at least insofar as they affect employees who are not bound by employment contracts containing non-compete clauses.

In *Quinonez v. National Association of Securities Dealers*, 540 F.2d 824 (5th Cir. 1976), securities dealers entered into an agreement prohibiting each from hiring any person who had been rejected for employment or discharged by one of the signatories. Plaintiff, a salesman who was discharged soon after being hired by one of the signatories, sued claiming violation of the Sherman Act and the Clayton Act. The district court dismissed the claim for failure to state a cause of action. The Fifth Circuit reversed, holding that the complaint which alleged "a blocking of interchange among employees of the securities

industry and synergetic threat of business boycott” stated a claim for relief under the Sherman Act and the Clayton Act. 540 F.2d at 830.

C. Tortious Interference with Contract

Tortious interference with contract requires a showing of (1) a contract; (2) the alleged torfeasor’s knowledge of a contact; and (3) his or her intentional procurement of a breach; (4) without justification; (5) resulting in pecuniary damages. Metropolitan Sports Facilities Commision v. Minnesota Twins Partnership, 638 N.W.2d 214, 228 (Minn. Ct. App. 2002); Kjesbo v. Ricks, 517 N.W.2d 588, 591 (Minn. 1994); Perry v. International Transp. Workers’ Fed., 750 F. Supp. 1189, 1201 (S.D.N.Y. 1990); Kronos, Inc. v. AVX Corp., 81 N.Y.2d 90, 595 N.Y.2d 931, 934 (1993); Kallock v. Medtronics, Inc., 573 N.W.2d 356, 362 (Minn. 1998) (If a non-compete agreement is valid and if the elements of tortious interference are established, interference with the non-compete agreement by a third party is a tort for which damages are recoverable.).

Systematic inducement of multiple employees of a single company to leave their present employment is unlawful when the purpose is to destroy a competitor or an integral segment of its business, rather than to obtain the services of skilled employees. Evidence that the loss of key personnel will harm the company, and that its rival desired to drive it out of business is important proof in these cases. Ecolab v. K.P. Laundry Machinery, Inc., 656 F. Supp. 894, 897 (S.D.N.Y. 1987). Evidence probative of intentional inducement to breach includes the offer of higher compensation packages and indemnity agreements in the event of litigation. Id. Once procurement of the breach by the defendant competitor is established, the burden shifts to the defendant to plead and prove justification for inducing the breach. Bogoni v. Friedlander, 197 A.D.2d 281, 610 N.Y.S.2d 511 (1994).

Whether interference is justified depends upon the circumstances of each case. The factors to be considered in such a determination are the nature of the conduct of the person who interferes, the interest of the party being interfered with (whether in an enforceable contract or in a voidable contract or a contract terminable at will), the relative merits of the rights affected by the conduct must be examined and the relationship between the parties. Guard-Life Corp., 50 N.Y.2d at 190 (defendant was not liable for alleged interference with exclusive distributorship contract where the contract was void for lack of mutuality); accord System Operations, Inc. v. Scientific Dev. Corp., 425 F. Supp. 130 (D.N.J. 1977) (interference with state-run lottery contract may have been privileged given the public interest at stake, but defendant’s actions did not justify application of privilege).

A tortious interference claim is unlikely to succeed when the competitor acts in accordance with a lawful purpose. See Conversion Equities, Inc. v. Sherwood House Owners Corp., 151 A.D.2d 635, 542 N.Y.S.2d 703 (1989) (cooperative apartment sponsors did not tortiously interfere with contractual relations where their actions were mandated by state and local law). However, when a competitor simply seeks to further its economic interest, his interference is unjustified. See State Enterprises, Inc. v. Southridge Cooperative Section 1, Inc., 18 A.D.2d 226, 283 N.Y.S.2d 724, 726 (1963); Avon Products, Inc. v. Berson, 206 Misc. 900, 135 N.Y.S.2d 867 (Sup. Ct. 1956).

D. Interference with Employment Relationships/Prospective Business Advantage

Even in the absence of employment contracts with its employees, an employer may be able to maintain claims against defecting employees and the competitors to whom they migrate. The general rule is that mere inducement of an employee to move to a competitor is not actionable where the employment is terminable at will. A competitor can be liable for inducing an employee to move to a competitor if the competitor employed means which were wrongful, malicious or designed to injure the plaintiff. Guard-Life Corp. v. S. Parker Hardware Mfg., 50 N.Y.2d 183, 194, 428 N.Y.S.2d 628, 634 (1980); Wear-Ever Aluminum, Inc. v. Towncraft, Inc., 75 N.J. Super. 135, 144, 182 A.2d 387 (Ch. Div. 1962); Diodes, Inc. v. Franzen, 260 Cal. App. 2d 244, 67 Cal. Rptr. 19, 26 (Ct. App. 2d Dist. 1968); see also Restatement (2d) of Torts §§ 768, 766 cmt. b (1979). Fraud, misrepresentation, intimidation, obstruction and molestation and the like are generally considered within the meaning of “wrongful or malicious means.” See Guard-Life Corp., *supra*; Wear-Ever Aluminum, *supra*; Diodes, *supra*.

E. Breach of Fiduciary Duty and Aiding and Abetting Breach of Fiduciary Duty

The Restatement (Second) of Torts § 874 comment c and § 876(b) impose liability on third parties if (1) there is a breach of fiduciary obligation; (2) the third party knowingly induced or participated; and (3) which resulted in damages. See Whitney v. Citibank N.A., 782 F.2d 1106, 1115 (2d Cir. 1986); American Republic Ins. Co. v. Union Fidelity Life Ins. Co., 470 F.2d 820 (9th Cir. 1972).

Firms may be found liable for inducing a competitor’s employee to recruit his co-employees while still employed. American Republic, 470 F.2d at 824; Augat, Inc. v. Aegis, Inc., 409 Mass. 165, 565 N.E.2d 415 (Mass. 1991). Firms may be found liable for assisting and benefitting from the efforts of a competitor’s employee to induce his customers to switch client accounts to the subsequent employer. IDS Life Ins. Co. v. SunAmerica, Inc., 958 F. Supp. 1258 (N.D. Ill. 1997), *aff’d in part, vacated in part*, 136 F.3d 537 (7th Cir. 1998); Everen Sec., Inc. v. A.G. Edwards & Sons, Inc., 719 N.E.2d 312 (Ill. App. Ct. 1999); Platinum Mgmt., Inc. v. Dahms, 285 N.J. Super. 274, 666 A.2d 1028 (N.J. Super. 1995); Hill v. Names & Addresses, Inc., 212 Ill. App. 3d 1065, 571 N.E.2d 1085 (Ill. App. Ct. 1991). Firms may be found liable for inducing a competitor’s employee “to divulge confidential information or to undermine his employer’s best interests.” Eurplast, Ltd. v. Oak Switch Sys., 10 F.3d 1266, 274 (7th Cir. 1993); see also RTL Distributing, Inc v. Double Batteries, Inc., 545 N.W.2d 587, 590 (Iowa App. Ct. 1996). Firms may also be found liable for inducing a competitor’s employees to terminate employment with a competitor, knowing their departure would cripple the competitor’s operations, Morgan’s Home Equip. Corp. v. Martucci, 390 Pa. 618, 135 A.2d 838 (1957); Duane Jones Co. v. Burke, 306 N.Y. 172, 117 N.E.2d 237 (1954); see also Randall Dairy Co. v. Pevely Dairy Co., 291 Ill. App. 280, 9 N.E.2d 657 (Ill. App. Ct. 1937) (affirming judgment for plaintiff where competitor persuaded plaintiff’s employees to terminate their employment and move to defendant), and generally assisting or encouraging a competitor’s employee to breach his duties to his employer. Restatement (Second) of Torts, § 876(b) 1977.

III. REMEDIES

A. Injunctive Relief

i. Temporary Injunction

NASD Code of Arbitration Procedure Rule 10335 allows parties to seek a temporary injunction from a court of competent jurisdiction. A party may seek a temporary injunction even if another party has already filed a claim arising from the same dispute in arbitration, provided that an arbitration hearing on a request for permanent injunctive relief has not yet begun. See Rule 10335(a)(1). If a party seeks a temporary injunction, the party must simultaneously file a statement of claim requesting permanent injunctive relief and all other relief with respect to the same dispute. See Rule 10335(a)(3).

Rule 10335 reflects recent amendments taking effect March 25, 2002. Under the new rule, stated above, temporary injunctive relief is not available within the arbitration process, rather, parties must seek relief from a court of competent jurisdiction. Under the old pilot rule, parties to intra-industry arbitrations could seek temporary injunctive relief either within the arbitration process or from a court. The new rule requires the expedited hearing in arbitration on the underlying dispute before a panel of three arbitrators. To expedite the hearing on the merits after a court has granted temporary injunctive relief, the new rule provides a shortened time frame for arbitrator selection. The new rule also clarifies the impact of a pending court order on the underlying arbitration, and provides guidance regarding the substantive legal standard applicable to request for permanent injunctive relief. See below.

In order to prevail on an application for a preliminary injunction, an arbitrator or court will consider: (1) the nature and background of the relationship between the parties preexisting the dispute giving rise to the request for relief; (2) the harm to be suffered by plaintiff if the temporary restraint is denied as compared to that inflicted on defendant if the injunction issues pending trial; (3) the likelihood that one party or the other will prevail on the merits when the facts situation is viewed in the light established precedents fixing the limits of equitable relief; (4) the aspects of the fact situation, if any, which permit or require consideration of public policy expressed in the statutes, State and Federal; (5) the administrative burdens involved in judicial supervision and enforcement of the temporary decree. Dahlberg Bros. v. Ford Motor Co., 137 N.W.2d 314, 321-322 (Minn. 1965); Metropolitan Sports Facilities Commission v. Minnesota Twins Partnership, 638 N.W.2d 214, 228 (Minn. Ct. App. 2002); Merchant & Evans, Inc. v. Roosevelt Bldg. Prods. Co., Inc., 963 F.2d 628, 632-33 (3d Cir. 1992).

In the usual case, a member firm seeks by application to obtain injunctive relief to enforce a non-compete clause of a purported employment agreement. When injunctive relief is sought for return of customer names or to prevent a former broker from soliciting the clients of his former employer, without a valid non-compete clause, arbitrators routinely reject injunctive relief, even if a breach can be shown. Likewise, a court will not usually grant an injunction prohibiting a former employee from soliciting a former employer's clients without a valid non-compete agreement. See Dean Witter v. Imperatore, Docket No. C-32-97E (N.J. Super. Ct., Ch. Div., Bergen County Feb. 14, 1997).

ii. Permanent Injunction

If a court issues a temporary injunctive order, an arbitration hearing on the request for permanent injunctive relief shall begin within 15 days of the date the court issues the temporary injunctive order. See NASD Code of Arbitration Procedure Rule 10335(b)(1). The legal standard for granting or denying a request for permanent injunctive relief is that of the state where the events upon which the request is based occurred, or as specified in an enforceable choice of law agreement between the parties. See Rule 10335(4). Subsection (4) is part of the new Rule 10335, discussed above, that went into effect March 25, 2002. It clarifies the legal standard applicable to permanent injunctive relief. In Minnesota, a party seeking a permanent injunction must show that legal remedies are inadequate and that the injunction is necessary to prevent great and irreparable harm. Cherne Industrial, Inc. v. Grounds & Assoc., 278 N.W.2d 81, 82 (Minn. 1979)

NASD arbitrators have refused to enjoin brokers from continuing to compete with their former employers or from continuing to use for that purpose copies they had kept of their client information. See, e.g., Vance v. Dean Witter, NASD Arb. No. 96-03325 (Aug. 13, 1996); Sullivan v. Dean Witter, NASD Arb. No. 96-03584 (Aug. 26, 1996); Edward D. Jones & Co. v. Nelson Olds, NASD Arb. No. 96-04636 (Oct. 23, 1996); but see Merrill Lynch v. Kramer, 816 F. Supp. 1242, 1246 (N.D. Ohio 1992) (enjoining former brokers from using confidential customer information); IDS Life Insurance Co. v. Sun America, Inc., 958 F. Supp 1258, 1278 (N.D. Ill. 1997).

B. Damage Awards

Generally, damages in raiding cases are based upon the lost profits of the raided firm. An expert witness qualified to testify as to lost profits is generally utilized. The claimant's expert should be able to clearly explain the loss of production attributable to the defecting manager and/or brokers. An analysis of the brokers' production at the new firm will add to an arbitration panel's appreciation of the total "loss," as will analysis of the "transition compensation" package paid to lure the defecting broker; it could be argued that the package was the "price tag" put on the defecting broker; an indication of the value of that broker's present and future production to a firm.

One (but certainly not the only) method to determine lost profits, is to subtract the branch's contribution to overhead (or local net profit) following the raid from the local net profit of the branch for an appreciable period prior to the raid (e.g. three years). If the former employer is able to put on its national sales manager or similar witness to testify that it will take a certain number of years for the branch to come back to its pre-raid production numbers, then a panel could determine the amount of total lost profits by multiplying those years by the amount of initial lost profits (i.e., pre-raid local net income less post-raid local net income).

An often-utilized defense is the speculative nature of calculating such lost profits. Another defense, in a situation where the defecting brokers have non-compete agreements, is to claim that the period of damages should only be calculated during the period of time covered by the non-compete agreement. Arbitrations have, however, disregarded such an argument. See Everen Sec., Inc. v. A.G. Edwards & Sons, *supra*, (arbitration panel awarded over \$1.1 million in lost profits even though the panel concluded the non-compete agreements were not enforceable).

i. Damages for Breach of Contract

In general, a plaintiff who successfully establishes that the defendant has breached an employment contract or has wrongfully taken and used trade secrets or confidential information may obtain both injunctive relief and damages. Cherne Industrial, Inc. v. Grounds & Assoc., Inc., 278 N.W.2d 81, 95 (Minn. 1979). Traditionally, the measure of damages for a breach of contract is the difference between the agreed upon contract price and the replacement cost. Where an employee wrongfully profits from the use of information obtained from his employer, the measure of damages may be the employee's gain Id. In addition, the tradition rule may not apply where the services of an employee are of a unique character such that it is difficult to replace them. See Valentine Dolls, Inc. v. McMillan, 25 Misc. 2d 551, 202 N.Y.S.2d 620 (Sup. Ct. 1960). Thus, lost profits may be an appropriate measure of damages where unique customer relationships are at issue. Where employment agreements contain "buy-out" provisions, calculations of the amount which must be paid as a result of early termination will ordinarily be enforced as the measure of contract damage. BDO Seidman v. Hirshberg, 93 N.Y.2d 382, 690 N.Y.S.2d 854 (1999). A violator of a covenant not to compete may be required to account for his profits, and such illegal profits may properly measure the damages. Petersen v. Johnson Nut Co., 297 N.W. 178, 182 (Minn. 1941).

ii. Damages for Tortious Interference with Contract

The measure of damages for tortious interference with contract is "the full pecuniary loss of the benefits of the contract with which" the defendant interfered. Guard-Life Corp. v. S. Parker Hardware Manuf. Corp., 50 N.Y.2d 183, 197, 428 N.Y.S.2d 628, 636 (1980). Once a party to contract has established that tortious interference by a third party has occurred, the courts may hold that third party liable for the resulting damages as well as grant injunctive relief. Kallock v. Medtronic, Inc., 573 N.W.2d 356, 361 (Minn. 1998) (citing Kjebos v. Ricks, 517 N.W.2d 585, 591 (Minn. 1994)).

iii. Damages for Breach of Fiduciary Duty

When an employee breaches his fiduciary duty to the employer, the employer is entitled to the amount the employer would have made except for the employee's breach of trust. Westwood Chemical Co. v. Kulick, 570 F. Supp. 1032, 1037 (S.D.N.Y. 1983). Ordinarily, breach of fiduciary results in complete forfeiture damages. Gilchrist v. Perl, 387 N.W.2d 412, 416 (Minn. 1986).

iv. Damages for Misappropriation of Trade Secrets

Where an employee wrongfully profits from the use of information obtained from his employer, the measure of damages may be the employee's gain. Cherne Industrial, Inc. v. Grounds & Assoc., Inc., *supra*. If defendant has diverted business that would have otherwise gone to the plaintiff, plaintiff may be entitled to damages equivalent to the profits realized by the defendant. Biltmore Publishing Co. v. Grayson Publishing Co., 272 A.D. 504, 71 N.Y.S.2d 337 (1st Dep't 1947).

v. Punitive Damages

Punitive damages are authorized in Minnesota under both common law and statute, specifically Minn. Stat. § 549.20. The statute allows punitive damages for a defendant that acts with “deliberate disregard for the rights and safety of others.” See Jensen v. Walsh, 623 N.W.2d 247, 251 (Minn. 2001). The general rule is that punitive damages are not recoverable in actions for breach of contract. Johnson v. Radde, 196 N.W.2d 478, 480 (Minn. 1972). Such damages may be recovered, however, where the breach has resulted from an independent or willful tort and the defendant has acted with malice. “Malice” necessary for the imposition of punitive damages is the intentional doing of a harmful act without legal justification. Id.

Arbitrators are authorized to award punitive damages. See NASD Code of Arbitration Procedure Rule 10214 (“The arbitrator(s) shall be empowered to award any relief that would be available in court under the law.”); see also John G. Kinnard & Co. Dain Rauscher, Inc., NASD Arbitration No. 98-00854 (Dec. 10, 1999); Principal Financial Sec., Inc. and Everen Capital Corp. v. Raymond James & Assocs., Inc., NYSE Arbitration No. 1998-007021 (Jan 10, 2000).

C. Attorneys’ Fees

In Intercity Co. Establishment v. Ahto, 13 F. Supp. 253 (D. Conn. 1998), the losing party in an NASD arbitration claimed that the arbitrators exceeded their authority in awarding attorneys’ fees because they were neither provided for by statute or enforceable contract. In upholding the award of attorneys’ fees, the Court noted that the NASD Code of Arbitration Procedure allows arbitrators to award “damages and other relief,” (see Rule 10330(e)) and went on to hold that “absent a provision in the arbitration agreement foreclosing attorney’s fees as a remedy, respondents were not precluded from seeking fees and there was nothing improper in their award.” See also PaineWebber, Inc. v. Bybyk, 81 F.3d 1193, 1202 (2d Cir. 1996). NASD Code of Arbitration Procedure Rule 10215 provides: “The arbitrator(s) shall have the authority to provide for reasonable attorneys’ fee reimbursement, in whole or in part, as part of the remedy in accordance with applicable law.”

In Minnesota, a court may not award attorney’s fees absent a specific contractual provision or statutory authority. Kallock v. Medtronic, Inc., 573 N.W.2d 356, 363 (Minn. 1998). In Kallock v. Medtronic, Inc., 573 N.W.2d 356 (Minn. 1998), the Minnesota Supreme Court held that a third-party’s interference with an employer’s valid non-compete agreement is a tort for which the employer may recover damages. The Court further held that when the third party’s interference with the non-compete agreement forced the employer into litigation to enforce the non-compete agreement, the employer may recover attorneys’ fees and other expenses under the third party litigation exception to the general rule that a litigant may not recover its attorneys’ fees and other expenses.

D. Freezing Customer Accounts

In December 2001, The NASD ruled that brokerage firms can no longer obtain temporary restraining orders to block customer account transfers. The SEC accepted this ruling when it was filed in late December 2001. Brokerage firms are not prohibited from obtaining TROs against former employees who defect to a competitor where the former employee has entered into a non-solicitation agreement prohibiting the broker from contacting clients.

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