

**ABA Section of Labor and Employment Law
Employee Rights and Responsibilities Committee**

EMPLOYMENT AGREEMENTS: AN OVERVIEW

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INTRODUCTION

An employer is free to offer employment contracts to all, some, or none of its employees. It's a very common practice for companies to offer contracts to higher-level personnel but not to rank and file employees. The only limitation on the employer's ability to offer contracts to some but not all employees is that the decision cannot be based on illegal discriminatory criteria (disability, race, gender, religion, age, or national origin, for example). This paper will explore the basic principles behind employment agreements and discuss considerations when drafting such agreements.

A. Should a Written Employment Agreement Be Utilized?

1. Advantages

- a. Requires parties to be precise and anticipate potential issues
- b. Avoids misunderstandings and faulty memories
- c. Avoids later claims of oral agreement
- d. For employer, permits control of certain employee behavior after termination, such as:
 - (1) working for a competitor
 - (2) starting a competing company
 - (3) solicitation of customers or employees
- e. May dictate use of arbitration to settle disputes between the parties and waive employee's right to sue employer in court
- f. For employee, increases financial security, a potential selling point in recruiting sought-after candidates
- g. More easily enforceable than oral agreement - - avoids Statute of Frauds problems.

2. Disadvantages

- a. Costs time and money to do well
- b. If negotiation goes poorly, may sour the relationship
- c. If poorly drafted, may saddle party with unintended obligations and create uncertainty
- d. For employer, generally takes the employment relationship beyond the normal employment-at-will status

B. Authorization to Represent Employer

Employer should limit by policy which agents of the employer may enter into a written agreement with an employee or who may alter the terms of an existing oral agreement.

C. Employment Agreement Checklist — Noncompensation Terms

An employment agreement should be limited to only those matters upon which written agreement is desired. Many of the items listed below are optional, but all are generally desirable.

1. Duties

- a. Title
- b. Reporting relationship
- c. Responsibilities and delegation of authority
- d. Mechanism for changing duties
- e. How and when performance will be evaluated

2. Term

- a. Duration — An employment agreement with no specified term and without any stated restrictions on the right to terminate is usually considered to be employment-at-will.
- b. Contingencies if there is a change in control of the company or financial distress
- c. Renewal
 - (1) Automatic renewal if no notice of cancellation (“evergreen” provision)

- (2) Renewal for a new term (evergreen renewal) so that remaining term under the agreement is always a set period
 - (3) Notice period for nonrenewal. May be different for employer and employee. Also specify how notice must be given (e.g., written notice delivered to a specified individual or by a particular type of mail).
 - (4) No provision of renewal. Contract will simply expire. But conduct of parties may create an implied renewal.
- d. Buy-outs — Can provide for employer to “buy-out” employee’s rights under the contract.

3. Termination Events

- a. For “cause”

Provisions usually specify specific reasons which constitute “cause” (e.g., failure to perform or gross negligence in performing of duties; serious illegal or immoral conduct), but may also state a general “Catchall” standard such as “good and sufficient cause” that can be applied to other unlisted circumstances.

- b. For other employer reasons, such as poor performance – this may or may not constitute “cause.”

- c. For no reason/without “cause”

Should provide extra consideration (e.g., severance pay or a longer notice period) or else a “no reason” provision may make the agreement illusory and rob it of binding intent. If employee is in a strong bargaining position, the penalty for a no-cause termination will be full pay and perhaps bonus for the balance of then contract term.

- d. Disability

A disability provision should specify that termination will result only if essential functions of position cannot be performed with or without reasonable accommodation or if health and safety are endangered. A termination for disability will be triggered only if the employee cannot perform the job for a specified length of time, such as four out of six months and/or 90 consecutive days. (Employers should keep in mind that the requirements of the ADA, FMLA and workers compensation law are not superseded by an employment contract)

4. Post-Employment Activity

a. Non-competition

Limitations on competition after termination must be reasonable as to geographic scope (under 100 miles is a good rule of thumb) and time (less than two years). If the agreement contains a non-compete clause, the agreement should not be a “take it or leave it” proposition; instead, the employee should be given an opportunity to negotiate the agreement. The employer should advise the employee to seek legal counsel to review the agreement, and the employee should be given adequate time to read and consider the agreement before he or she is expected to sign. If the job is unique or requires special skills, it is a good idea to state that with as much specificity as possible. The employer may want to link the observance of the non-compete provision to the receipt of severance pay as such an arrangement would enhance the enforceability of the provision.

b. Non-solicitation of customers

May restrict future by ex-employee with company customers, but only to the extent necessary to protect legitimate company business interests and/or trade secrets. This provision should also be limited to a specific time period.

c. Non-solicitation of employees

May restrict future solicitation by ex-employee of company employees. Of course, if such action is undertaken while the individual is still employed, there can be a breach of loyalty independent of any contractual violation.

d. Confidential information and trade secrets

This is a very useful provision as it alerts the employee to the need to treat confidential information carefully from the very beginning of the employment relationship. It is important to specify in concrete terms what is considered confidential. The provision should specify that the employee is required to safeguard trade secrets or confidential information and not disclose it to anyone who is not authorized to know it. Trade secrets will be protected by common law even in the absence of a contractual provision, but the contract may provide for better enforcement (e.g., by containing an “irreparable harm” provision) and for agreed upon damage (e.g., via a liquidated damages provision).

e. Inventions or creative material

Ownership of rights to patents, inventions, or copyrights obtained by the employee during employment, or as a result of work done while employed, and any royalties or other payments resulting from such items should be specified. In addition, any written or artistic material should be designated as the property of the employer.

f. Conflicts of interest

Such provisions usually prohibit the employee from engaging in activity that competes with or jeopardizes the well-being of the employer. May want to specify that during the employment period all of the employee's business time and attention will be used for the work of the employer (however, usually carve out an exception for non-conflicting charitable and civic activities).

5. Indemnification

Circumstances under which the employee will be defended and/or indemnified may be defined. Check the employer's corporate by-laws and laws of the state of incorporation first as they may already provide the employee with certain indemnification rights. Also, check how this type of defense will be treated under the employer's insurance coverage.

6. Special Issues

a. Transfers and overseas assignments

If out-of-the-ordinary transfers or assignments are possible, such a provision should state how problems will be resolved and how economic issues will be handled (cost of travel and moving to new location, storage of household goods, international tax issues, travel home, family issues of education and medical care).

b. Relocation Expenses

Unless already covered in a policy manual, circumstances under which relocation expenses (house-hunting trips, travel to the new location, packing and moving of household goods, temporary living expense) should be specified. The employee may incur increased tax liability due to the value of these benefits. Whether the employer will provide tax gross-up payments to cover these extra taxes should also be specified.

c. Special education and training

If employer-paid education or training is anticipated, service requirements and possible exceptions should be specified.

D. Employment Agreement Checklist — Compensation

The complexity of compensation packages varies with the employee's position with the company. As a result, many, but not all, of the following features will be applicable for a given situation.

1. Total Compensation Package

- a. Base salary
- b. Benefits

May want to reference that benefits will be provided under the terms of employer's benefit plans, as amended from time to time or may want to list the benefits themselves, but should state that the terms of those plans govern. Often, the contract will merely provide that the employee will receive the same benefits that are provided to other employees of similar level of responsibility, e.g., to "other executive employees."

- c. Signing bonus or make-whole payments
- d. Short-term incentives/bonus
- e. Long-term incentives/bonus
- f. Severance package

2. Base Salary

- a. Amount (subject to withholding and payroll taxes, as applicable); usually given as a "rate," rather than as a guaranteed sum
- b. Mechanism and timing for review (will the initial amount be a guaranteed floor, or can it be decreased? Are increases assumed?)
- c. Frequency of payment

3. Short-Term Incentives

- a. Cash pay "at risk"
- b. Annual cash bonus programs and target amounts
- c. Selecting and specifying performance measures/benchmarks/formulae

4. Long-Term Incentives

a. Non-qualified stock options versus incentive stock options

Non-qualified stock options are options which do not comply with Internal Revenue Code requirements for incentive stock options. At the time the option is exercised the employee will recognize the value of the stock over the price of the option as ordinary income. The company will be entitled to deduct the same.

Incentive stock options must meet specific requirements of the Internal Revenue Code, including: (i) the option may not be exercisable after the expiration of ten years from the date the option is granted, and (ii) the option price may not be less than the fair market value of the stock at the time the option is granted. At the time the option is exercised, the employee does not incur any taxable income. If the employee holds the stock for at least one year after exercise, on sale of the stock acquired through exercise, long-term capital gain will be recognized. The employer is not entitled to any deduction.

b. Stock Appreciation Rights

Often granted in tandem with stock options to generate the cash needed to exercise an option. On exercise, SARs entitle the employee to receive an amount equal to the appreciation in the stock beyond the price at which the SAR was granted.

c. Phantom Stock

An agreement under which the employee is treated as if he or she had received shares of company stock. The equivalent of dividends are generally paid to the employee, allowed to be reinvested to purchase additional units, or deferred with interest.

d. Restricted Stock Plans

Usually a grant of stock which will vest in increments over time (e.g., 25% of the grant on each of the next four annual anniversaries of the grant date). Often, the employee must hold the stock for a specified period of time.

e. Employee Stock Purchase Plans

This type of plan grants options to purchase employer stock and must meet numerous requirements of the Internal Revenue Code. If the requirements are met, and if the disposition occurs two years or more after the date the option is granted and the employee holds

the stock for at least 12 months after exercising the option, any profit to the employee will be taxed as capital gain.

5. Severance Packages

- a. Negotiated arrangements for severance may be part of the employment agreement; often link a severance package with non-compete or non-solicitation provisions and an agreement to execute a general release of claims as a condition for receiving severance. Sometimes there will be a salary continuation period during which the employee remains in that status, followed by a severance payment which may be made over time or in a lump sum.
- b. Address whether benefits will be continued for severance period.
- c. May be triggered either by termination of employee by Company without “good cause,” or resignation by employee for “good reason.”
- d. Golden parachutes

Payments made after change in control. A single trigger provision pays the golden parachute after the change in control alone, even if the employee continues working for the company. A double-trigger provision requires a change in control plus a change in the employee’s terms of employment. If a golden parachute exceeds three times the average compensation for the five years prior to the change in control, the employee will incur excise tax and the payment is nondeductible by the company.

6. Privately Held Companies

- a. Equity-based compensation or alternative cash-based compensation tied to performance objectives
- b. Valuation of stock or phantom units is often difficult; the method to be used should be stated in the employment agreement.
- c. Exit strategy; who gets equity in a buy-out

7. Sample Term Sheet is attached as Exhibit A

E. Additional Considerations

1. Blue Penciling

Agreement should state that if a court finds any part of the agreement unenforceable the balance shall still be a valid contract, and also that any term deemed unenforceable/unreasonable by a court may be reformed or modify so as to make it enforceable/reasonable.

2. Gag Rule

May want to prevent the employee from making disparaging or harmful remarks about the company both during and after the employment term; such a provision should include an exception for statements made under compulsion of lawful process or as may otherwise be required by law (the employer does not want to suborn perjury, or interfere with a government investigation).

3. Signatures

Agreement should state that the signatures of the parties may be on separate signature pages. Allowing this often facilitates the execution of the document. It may also provide for multiple original copies, so both the employee and the company have signed originals of the agreement.

EXHIBIT A

Sample Checklist for
Employment Agreement
Between Corporation and Executive

| <u>Item</u> | <u>Provision</u> | <u>Terms</u> |
|-------------|---|--------------|
| 1. | Term of Employment | • |
| 2. | Position; Title; Duties; Responsibilities; Reporting; Place of Business | • |
| 3. | Base Salary | • |
| 4. | Annual Short-Term Incentive Compensation | • |
| 5. | Annual Long-Term Incentive Compensation | • |
| 6. | Sign-On Arrangements | |
| | (a) Sign-On Inducement Grant | |
| | (b) Sign-On Make-Whole Stock Award | |
| | (c) Sign-On Make-Whole Cash Award | |
| 7. | Employee Benefits and Perquisites | |
| | (a) Benefits | |
| | (b) Perquisites | • |
| 8. | Reimbursement of Business Expenses | • |
| 9. | Termination of Employment | |
| | (a) Death | • |
| | (b) Disability | • |
| | (c) Termination Without Cause or Termination by Executive for Good Reason | • |
| | (d) Voluntary Termination | • |
| | (e) Termination for Just Cause | • |
| | (f) No mitigation, no offset | • |

| | | |
|-----|--|----------------------------------|
| 10. | Change of Control and Termination | • |
| 11. | Indemnification | |
| 12. | Confidential Information | |
| 13. | Non-competition; non-solicitation of customers and employees | |
| 14. | Representations | • |
| 15. | Dispute Resolution | |
| 16. | Definitions | See Schedule A, attached hereto. |
| 17. | Employment Agreement | |

Schedule A

SAMPLE DEFINITIONS

| | |
|---|---|
| <p>“Just Cause” means:</p> | <p>(i) Executive pleads “guilty” or “no contest” to or is convicted of any act which is defined as a felony under federal or state law; or</p> <p>(ii) In carrying out his duties, he engages in conduct that constitutes willful gross neglect or willful gross misconduct resulting, in either case, in material economic harm to the Company.</p> <p>There shall be no termination for Cause without his first being given written notice of the basis for the termination and an opportunity to be heard by the Board.</p> |
| <p>“Change in Control” means an occurrence of any one or more of the following:</p> | <p>(i) A takeover bid (within the meaning of the Securities Act), or</p> <p>(ii) any of the following occur: (A) any consolidation, merger or amalgamation of the Company with or into any other corporation whereby the voting shareholders of the Company immediately prior to such event receive less than 50% of the voting shares of the consolidated, merged or amalgamated corporation ; (B) a sale by the Company of all or substantially all of the Company’s undertakings or assets; (C) a proposal by or with respect to the Company being made in connection with a liquidation, dissolution or winding up of the Company; (D) any reorganization, reverse stock split or recapitalization of the Company that would result in a Change of Control as otherwise defined herein; or (E) any transaction or series of related transactions having, directly or indirectly, the same effect as any of the foregoing.</p> |
| <p>“Disability” means:</p> | <p>Executive’s failure by reason of illness, disease or physical or mental disability to substantially perform the duties and responsibilities of his employment with the Company for a period of six consecutive months.</p> |

| | |
|-----------------------------|--|
| <p>“Good Reason” means:</p> | <ul style="list-style-type: none"> (i) A material diminution in Executive’s title or duties or assignment to Executive of materially inconsistent duties; (ii) a reduction in his then current Base Salary or target bonus opportunity as a percentage of Base Salary except for across the board cuts applicable to all employees at employee’s level; (iii) a change in the reporting structure; e.g., Executive no longer reports directly to the Board; (iv) relocation of Executive’s principal place of employment exceeding 50 miles; (v) a material breach by the Company of any provisions of this Agreement; (vi) the failure of the Company to obtain the assumption in writing of its obligation to perform this Agreement by any successor to all or substantially all of the assets of the Company within 15 days after a merger, consolidation, sale or similar transaction; or (vii) in the event of a Change in Control of the Company, Executive is not offered the same or equivalent position or more responsible in the newly combined entity. <p>There shall be no termination for Good Reason without written notice from Executive describing the basis for the termination and the Company’s having a reasonable period to cure.</p> |
|-----------------------------|--|