

# NEGOTIATING EXECUTIVE EMPLOYMENT AGREEMENTS ON BEHALF OF THE EMPLOYEE<sup>1</sup>

by:

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## I. INTRODUCTION

Written employment agreements have become commonplace for executive employees. An employer might want to negotiate an employment agreement to attract and retain high-level talent. Such an agreement can be even more useful to an employee in providing job protection, protecting against an employer's potential fickleness, increasing the value and comprehensiveness of the compensation package, and easing the employee's exit as her employment with that company ends.

This article outlines a number of issues for consideration by attorneys representing employees seeking a written agreement,<sup>3</sup> or responding to an agreement proffered by a prospective employer. Specifically, via a written agreement the employee can obtain an all-inclusive, carefully-considered and clear description of her various forms of compensation and benefits. She can also obtain protection from a change of mind, a change in structure, or a change in control at the company, by securing advance agreement for a dignified and appropriately compensated exit should one of those events occur.

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<sup>2</sup> The sections of this article on the role and significance of Section 409A of the Internal Revenue Code were written with the assistance of Leslie Crane Slavin, Esq., Lourie & Cutler, P.C., 60 State Street, Boston, MA 02109, 671-742-6720, [lsalavin@louriecutler.com](mailto:lsalavin@louriecutler.com), a tax lawyer whose skill in assisting non-tax lawyers with tax issues is second to none.

<sup>3</sup> Any U.S. tax advice contained in this article is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

## **A. ROLE OF COUNSEL**

A prospective employee typically begins negotiation with the employer without the advice of counsel. Because the individual might have a solid understanding of prevailing compensation packages from employers in the particular industry, this may not necessarily be harmful. However, an experienced attorney may also have an informed understanding of such packages, and indeed may have represented other individuals in similar negotiations or even parallel negotiations with the same employer. Moreover, the employer typically starts with a boilerplate agreement drafted by its counsel, the economic and legal terms of which are likely skewed in the company's favor. A savvy employee-side lawyer may be able to make major inroads into the boilerplate, which can make it beneficial to bring such counsel into negotiations sooner, rather than later.

An employee lawyer's participation need not be open. Many employees may be better off starting and even continuing negotiations directly with their prospective employers, rather than relying on lawyer-to-lawyer bargaining, for several reasons. First, starting off an employment relationship by formalizing and elevating such negotiations to the lawyer level tends to take the blush off even the brightest-blooming new-job rose, by creating an adversarial posture between the principals. Second, the power of the employer's mating instinct--its desire to ensure that the company retains its attraction for the job prospect--may lead companies to offer terms in direct negotiations that might never see daylight if first vetted through company counsel.

Of course, this does not mean that counsel should play a minor role. Lawyers can be extremely useful to employees in advising them in the background while the employee is dealing directly with the employer. A lawyer may often usefully surface at a later point in the negotiations and participate personally. Some issues are simply too technical for clients usefully to negotiate between themselves, and sometimes lawyers joining an ongoing dialogue can help the parties extricate themselves from impasse.

## **B. A NOTE ON TAX ISSUES**

Every lawyer participating in employment-contract negotiations needs to be acutely aware that tax issues have become central to the process. Many features of an employment agreement might be affected by tax law. Recently, new concerns have arisen due to the passage of section 409A of the internal revenue code hereinafter (§ 409A), which imposes a new set of very strict rules on non-qualified deferred compensation arrangements. Section 409A generally applies to compensation deferred after December 31, 2004. The provision is extremely far-reaching, covering many arrangements that have not traditionally been considered to be deferred compensation plans. Section 409A can affect even routine provisions in employment agreement such as those dealing with contract renewal, bonuses, reimbursement of expenses, and severance pay, in addition to those provisions that deal with more traditional (and recognizable) forms of deferred compensation. Failure to spot and deal with issues raised by § 409A could result in accelerated income taxes, interest, and a 20% penalty being imposed on the employee, your client.

A full discussion of 409A and other tax issues is beyond the scope of this article. However, throughout this article we have highlighted certain provisions in employment agreements that might warrant particular attention to the requirements and consequences of tax law. Plan to keep your tax adviser on speed-dial as you and your client work your way through these negotiations.

## **II. DEFINING THE EMPLOYMENT RELATIONSHIP**

### **A. REPRESENTATIONS ABOUT THE EMPLOYEE'S OBLIGATIONS TO PRIOR EMPLOYERS OR ENTITIES**

At the outset, an employer may want a prospective employee to represent that she has no current obligations to other employers or entities, especially where the employee has been employed in technical or sales positions, and particularly in industries where covenants restricting competition or disclosure are common (e.g., the high-tech and biotech industries). The employer will want to ensure that the employee is free to work for the company, and to assign to the employee the risks and costs of resolving any problems if achievement of that goal is threatened.

Where an employer insists on such representations (especially where the employee has signed a non-compete agreement with a previous employer), the employee should seek, correspondingly, to have the new employer assume that risk, or at least to share that risk with the new employer. The employee's goal is to have the employer's counsel review the existing non-compete agreement and acknowledge in writing that the new employer does not perceive a conflict between the new job and the previous employer's covenants. The employee should also seek an agreement that the new employer will defend the employee at its expense against potential enforcement claims brought by the former employer.

### **B. RELOCATION PACKAGE**

Where an employee is being recruited and asked to relocate by the employer, the employee should negotiate a relocation package that will cover both the "buy" and "sell" ends of her move (e.g., negotiate for points and expenses of the new purchase, as well as the payment of the broker's commission on the sale of the employee's old house), including house-hunting trips (for the employee and her spouse), provision of temporary housing, packing, moving, and unpacking expenses, storage costs, replacement of major appliances, and any long-distance commuting costs. Depending on real estate market conditions, the employer might agree to buy the employee's former residence and assume the responsibility and risk of resale.

### **C. TERM OF EMPLOYMENT AND RENEWAL PROVISIONS**

The term of employment may be "fixed" (i.e., for a set number of months or years) or indefinite. Generally, a fixed-term contract, or fixed-term with an automatic

extension, is better for the employee than an indefinite-term contract. The contract should spell out whether (and if so, how) it is renewable, or alternatively provide that it is automatically renewed absent a specified form and period of notice to the contrary. The employee is much better served by such a provision, since it is unclear in many states whether continued performance by the employee after the fixed term elapses will renew the contract, or will simply convert the contract into an at-will relationship.

If a contract renewal involves a renegotiation of terms, care must be taken not to inadvertently accelerate or defer deferred compensation payments in violation of §409A. See your tax specialist about this.

#### **D. JOB TITLE AND REPORTING RELATIONSHIPS**

The contract should set forth the exact employing entity or entities. Identification of the employing entity is especially important where an employee is seeking to work for a multi-tiered or multi-jurisdictional corporation with many divisions. The agreement should also state the employee's job title and reporting relationships, both identifying the positions to which the employee reports, as well as the positions that will report to the employee. The more precision, the greater protection against unwanted transfers or demotions (disguised or otherwise).

#### **E. DUTIES AND RESPONSIBILITIES**

Spelling out the employee's specific duties and the scope of her responsibilities in the agreement helps clarify the scope of the employee's job. Equally important, it can protect the employee against constructive demotion by the employer (in the form of diminished duties or responsibilities). The employee should resist the employer's preference for flexible language (e.g., "all (or 'any other') duties assigned by the employer"). If the position entails job responsibilities that are too detailed or too many to include in the text of the contract, a comprehensive job description might be appended to the employment agreement.

The agreement should also indicate the location(s) at which the employee is to work. If the employee is concerned about being transferred to other locations (especially when such transfers include a residential move), then counsel should negotiate limits on the company's unilateral ability to make such transfers. Such limits might include the conditions under which such transfers would be made and the locations to which the employee might be transferred. The agreement should also address payment of relocation costs in the event a transfer requires moving her residence. (See discussion above in § II(B) above.)

The following issues should also be addressed in the agreement, to the extent they reflect the employee's concerns: travel obligations, working hours, and any other working conditions that might pertain to employees in the particular industry.

The employee should seek clearly defined performance standards and criteria for evaluation. These should be objective and specific, and ideally tied to specific time lines.

The employee may also want to consider delineating other aspects of her employment, such as involvement on the company's board of directors or trustees, as well as specifying any limitations on (or specific permission to perform) outside activities such as board memberships with other for-profit or non-profit organizations, commercial enterprises, or charitable endeavors.

## **F. COMPENSATION PACKAGE**

### **1. “Basic” Compensation Components**

The employment agreement should set forth the financial compensation that the employee will receive, starting with the employee's base salary and commission plan, if any. It is important to negotiate for minimum annual increases in base salary. Commissioned employees should seek a minimum "floor" level for commissions or a guaranteed draw.

The executive employee's compensation also may include bonuses (including signing bonuses and short- and/or long-term incentives). Incentive plans may be based on the market performance of the employer and/or the personal performance of the employee. The agreement should define criteria and eligibility for bonuses, and the schedule on which bonuses are payable.

Any bonus provisions should be examined for compliance with §409A. A bonus arrangement should specify form of payment (e.g. lump sum payment) and time of payment (e.g. as soon as practical after completion of 12 months of employment). If a bonus must be paid within a short period of time after it is vested (i.e. no later than 2 ½ months after the close of the year in which it becomes vested), then it is exempt from §409A. However, the specification of payment timing is important to establish the exemption. Alternatively, if the bonus arrangement is subject to §409A, then the payment timing becomes crucial for compliance. This is another area where technical tax advice is needed.

The employee should try to ensure that any "signing bonus" is not tied to a minimum period of service with the employer; to avoid language requiring payback of the bonus if the employee is employed less than a certain number of months or years; to utilize objective standards to determine whether the bonus is paid and its amount, rather than leaving the bonus or its amount to the employer's subjective decision-making; and to seek proration of the bonus if employment begins in the middle of a bonus year. The employee may wish to propose minimum bonus amounts, especially where she is being courted to leave a secure and well-compensated position.

The employee may wish to consult the employer's employment manual to review the employer's existing bonus plans, and use that as a starting point for her own negotiations.

## 2. **“Basic” Benefits**

The employment contract should be used to spell out the benefits to which the employee is entitled. Again, the employee should first review the employer's employment manual as well as all benefit plans and materials. Many employers provide, or can be persuaded to provide, "enhanced" benefits packages to executives, which are sometimes individually tailored and not otherwise described in writing. These include comprehensive medical, dental, and vision insurance, as well as high levels of life, accident, and disability insurance coverage.

The employee should also secure agreement as to the amount of vacation and other absences permitted, remembering to spell out how vacation time will increase in tandem with increased service.

## 3. **Fringe Benefits**

The executive employee should try to enumerate in the agreement the fringe benefits ("perks") that will accompany her position. These may include the employer's payment for "business expenses" (e.g., subscriptions, entertainment, matching charitable contributions, etc.); accessories (e.g., cell phone, laptop computers, PDAs), home-office equipment; professional fees and club dues; conferences and seminars (the employee should try to specify a minimum dollar amount, or particular meetings or conferences as a minimum commitment); travel (ensuring travel by business class or better, and reimbursable travel expenses); corporate automobile (and parking space); and services such as financial, tax, and estate planning.

If it is anticipated that the employee will have to travel frequently for long time periods, she may seek compensation for interim home visit travel expenses, to be paid by the employer (particularly where the employee's schedule would otherwise keep her away from home two or more consecutive weekends).

If the employer chooses to reimburse the employee for certain expenses, then §409A becomes relevant to those categories of expense reimbursements that are classified by the IRS as constituting taxable income. Examples include non-business use of business vehicles such as airplanes or automobiles. Final IRS regulations provide that the taxable reimbursement of expenses or the provision of taxable in-kind benefits meets the requirement of a specified date or schedule for payment (see § II (5) below for a discussion of this requirement) if the following conditions are met:

- There is an objectively determinable, nondiscretionary definition of the expenses that will be reimbursed or in-kind benefits that will be provided;

- The period for which such benefits will be provided is described;
- The amount of reimbursements or in-kind benefits provided in one year cannot affect the amount available in any other year;
- The reimbursement is made no later than the end of the year following the year in which the expense was incurred;
- The right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.

#### **4. Deferred Compensation**

##### **a. Equity Compensation In General**

Increasingly, employees are receiving equity compensation in some form of ownership interest in the employer as an incentive for performance. In theory, equity compensation rewards the employee if the company's value increases. Such compensation is provided as an incentive to retain employees and spur their performance. It may be based on the achievement of specific performance goals by the employer and/or the employee.

Equity compensation typically "vests" over time; the employee becomes eligible for this equity as her service increases. The terms of vesting may or may not be negotiable, depending on the type of equity and the terms of the various equity plans. It is especially frequently used in start-up companies, where the employer may have limited assets, but great potential for growth.

The employee should remember that the employer uses equity compensation as "golden handcuffs" to prevent the employee from leaving before her equity interests vest. Thus, it is preferable for the employee to seek a faster (or shorter) vesting schedule.

To protect against deprivation of benefits prior to vesting, the employee should negotiate terms that accelerate vesting in the event that her employment is terminated by the employer without good cause (see §V, *infra*). Further, the employee should try to obtain agreement that her options will vest upon a change of control of the company ("single trigger"). As a second-best alternative, she should seek acceleration of the vesting schedule upon a "double trigger" - i.e., a change of control of the company and the employee's termination (or her resignation for "good reason").

It is crucial for the employee's attorney to carefully review all plans governing equity compensation to which the employee is entitled. The employee should secure specific advice regarding the tax ramifications of various types of equity compensation. She should also consider the effects of stock market decline on her employment package.

Additionally, some plans may be subject to disclosure rules set by the Securities and Exchange Commission. Executives with material, non-public information should beware of provisions in securities laws against "insider trading," and should look for "windows" (authorized, limited trading periods) or check with corporate counsel before engaging in trades.

The following are examples of equity compensation to which employees may be entitled.

### **b.       Restricted Stock**

Restricted stock is typically stock for which the employee pays nothing (or may pay all or part of the fair market value of the stock). This is usually subject to vesting, and the employer may attempt to retain "buyback rights" upon the termination of the employee's employment, usually allowing the employer to repurchase the stocks upon the employee's termination at, or close to, cost.

Of course, employees should resist buyback clauses. If resistance is unavailing, employees should negotiate a buyback price at fair market value (with the purchase price plus interest as a floor to protect against a drop in market value).

In general, grants of unrestricted stock, not subject to vesting, to employees are immediately taxable, at ordinary tax rates. However, where grants of stock are subject to a vesting schedule, taxability is deferred until the stock is vested unless the employee elects under IRC §83(b) to be subject to tax currently. If the employee defers taxation until time of vesting, the then value of the stock (minus the amount, if any paid for the stock) will be subject to tax as compensation income. Appreciation occurring after vesting will be taxed, when the stock is sold, as capital gain income. However, if a §83(b) election is made, the employee will pay tax, at ordinary income rates, on the excess of the value of the stock when transferred over the amount, if any, paid for the stock. Any appreciation that occurs thereafter will be taxed at capital gains rates when the stock is sold. Note that true restricted stock is not covered by §409A, but restricted stock unit plans are covered.

### **c. Incentive (Qualified) Stock Options**

Incentive stock options ("ISOs") provide the employee with an option to purchase a set number of shares of stock. The employee's ability to exercise the options typically vests over a period of time, on an annual, biannual, or quarterly basis. ISOs are a generally preferable form of compensation for the employee because they are tax-qualified - i.e., not taxable upon grant by the employer or exercise by the employee. The employee only incurs tax liability upon the capital gain when the stock is ultimately sold. ISOs are typically not transferable except upon the death of the employee. (ISOs are generally exempt from §409A.)

To preserve their tax-qualified status, ISOs must fully vest within ten years (most vesting times are much shorter - i.e., three to five years), and must be exercised within

three months of the termination of employment. ISOs must be set forth in written stock option plans, which the employee and her attorney should review closely.

The employee should monitor the value of the company's stock. She may be disadvantaged if the price of the company's stock is escalating while hiring negotiations continue, or if the price of the stock declines after the employee has become locked into a specific option price. The employee can try to get around the latter problem by asking the employer to agree formally to lower the option price if the market value of the stock declines (if the terms of the plan permit such an arrangement). Note that many companies will lower the option price in accord with the market in any event.

#### **d.        Nonqualified Stock Options**

Nonqualified stock options are another form of equity compensation that typically vests over time. They allow the employee to purchase the company's stock at a price below its fair market value. They are taxed immediately if the fair market value of the stock is readily ascertainable and the option is not transferable. Otherwise, income is recognized for tax purposes upon the employee's exercise of the option.

Note that because these options are not tax-qualified, there may be no associated "plan" to review (unlike qualified options), making it all the more critical for attorneys to specify the terms of such awards with precision in employment agreements.

If a non-qualified stock option is issued at a price at least equal to the fair market value of the stock at the time of the grant of the option, the option will generally not be subject to §409A (unless the option contains other elements of income deferral). If, however, the option is a discounted option, it will be subject to §409A, which renders the option significantly less attractive because an exercise date must be specified or the delivery date must be specified and deferred. Since the passage of §409A, most non-qualified options are non-discounted options.

#### **e.        Stock Appreciation Rights**

Another form of equity compensation is stock appreciation rights ("SAR"). A SAR is a contractual right to receive, either in cash or employer stock, the appreciation in the value of the employer's stock over a period of time. No actual stock is issued. When SARs are used, the complications and risk of capital investment, and the need for liquidity to purchase stock, are eliminated for the employee.

When the employee's employment terminates, or upon other specific triggering events (usually death, retirement, or change of control of the company), the employee becomes entitled to exercise the SARs. The amount paid (in cash or stock) is the difference (appreciation) between the value of the stock on the date the SARs are granted and the value of the stock on the date it is exercised.

The employee is only taxed upon exercise of the SAR. If she elects to receive the appreciation as cash, it is treated as ordinary income. If she elects to receive the appreciation in stock, she is liable for tax on the difference between the stock's fair market value and the amount she paid for it, so long as there are no restrictions on the stock.

For §409A purposes, stock appreciation rights are treated similarly to non-qualified stock options. In other words, if compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock on the date the right is exercised over an amount specified on the date of the grant and the exercise price may never be less than the fair market value of the underlying stock on the date the right is granted and the right does not include any other feature for the deferral of compensation, then the right will not be subject to §409A.

#### **f. "Phantom Stock"**

"Phantom stock" is similar to stock appreciation rights in that no stock is actually issued to the employee. Instead, the employee is awarded bonuses in the form of hypothetical ("phantom") shares of stock, representing hypothetical percentage ownership of the employer. These phantom stocks are credited to an account set up for the employee, and the employee's benefit increases with the growth of these shares. Under this practice, company principals retain voting power and all shareholder rights. Employees negotiating employment agreements should consider seeking phantom stock where the employee seeks to benefit from the company's growth but prefers to avoid the costs and risks of actual ownership.

Generally, there are two types of phantom stock plans: "basic" plans and "growth" plans. Under either plan, as with stock appreciation rights, the employee may exercise the plans when her employment terminates, or upon other specific triggering events (usually death, retirement, or change of control of the company).

A growth plan resembles stock appreciation rights: when the employee exercises her option, she is entitled to receive an amount equal to the excess (if any) of the market value of all of her phantom shares on the date of exercise, over the value of the shares on the date(s) on which they were awarded.

Under a basic plan, the employee receives the value of the phantom stocks issued, not merely the appreciation of same. Basic plans guarantee that the employee receives something for her shares, even if the market value of the stock when exercised is less than it was at the time the shares were issued.

The income tax consequences are similar to those for stock appreciation rights and deferred compensation plans (see below): the employee is not taxed until the moneys are actually paid out to her.

Phantom stock plans are subject to §409A.

**g. Other Forms of Deferred Compensation**

Sometimes, the employer has other, existing deferred compensation plans. These may be set forth in the employer's handbook, but not necessarily. In any event, an employee can negotiate an individually-tailored plan. The employee's goal in doing this is typically to defer payment of taxes on part of her compensation. Sometimes, but not always, these plans are funded by the employer. The funds set aside may or may not be subject to vesting or forfeiture; the employee should try to negotiate to eliminate these restrictions, and to negotiate accelerated vesting plans in the event that the employee's employment is terminated.

Note that when employer funds are not segregated and dedicated to fund such plans, they are even less secure than the funded plans described above. Some companies are poor candidates for a form of compensation that assumes the company's existence, liability, and solvency years into the future.

Note that all traditional deferred compensation plans and individual agreements must be written and must comply with the requirements of §409A. Even plans instituted before the effective date of §409A must be amended to comply. In years past, these plans frequently allowed the employee to select a form of payment (e.g. installments or lump sum) close to the time payment was scheduled to begin. They often permitted the employee to receive an early distribution if a penalty, such as a 10% reduction in payment amount, was imposed. Neither of these provisions is currently allowed and should not be written into any agreement.

**5. Important new tax rules governing non-qualified deferred compensation**

As noted above, section 409A imposes a new set of very strict rules on non-qualified deferred compensation arrangements. The provision is extremely far-reaching. For example, section 409A can affect severance arrangements, change-in-control agreements, annual bonus arrangements, retention bonuses, transaction bonuses, long-term incentive plans, discounted stock options, phantom stock plans, reimbursement arrangements, as well as supplemental executive retirement programs (SERPS), excess plans linked to qualified retirement plans, and other traditional deferred compensation plans.

Among other things, §409A requires that:

- The election to defer compensation for services performed in one year must be made no later than the close of the preceding taxable year. The election to defer must also include an election as to time and form of payment. Even if the deferral is non-elective, the time and form of payment must be specified in advance.

- Once compensation has been deferred, it may only be distributed upon separation from service, disability, death, a previously specified time (or pursuant to a fixed schedule), a change in control, or unforeseeable emergency.
- Certain key employees of public companies must wait for 6 months after separation from service before collecting their deferred compensation. Note that this provision may significantly affect severance negotiations.
- The ability to defer payment beyond the originally scheduled payment date is severely restricted.
- The ability to accelerate payment is virtually non-existent.

## **6. Intellectual Property and Business Property Rights**

Typically, companies in the business of developing products will insist that employees assign rights to inventions (or improvements to the employer's products or processes implemented by the employee) to the employer. The employee should be aware that employers sometimes attempt to assert rights to intellectual property that the employee has created before working for this employer or after her employment ends, or in a side business while employed. The employee should be sure to demonstrate ownership of intellectual work she developed before or after commencing employment with the employer, and limit the employer's right to products developed (or improved) in the course of employee's actual service to the company.

## **7. Expatriate Benefits**

An employee who is contemplating a position with a new employer that may involve an overseas tour of duty should negotiate for benefits that exceed those discussed above for employees who are relocating within the United States, because of the added expenses and burdens of working in a foreign country. Many multinational employers have formal policies regarding expatriation, and the employee and her attorney should review these carefully and use them as a starting point for negotiations.

The employee should make sure that the employer's expatriate benefits package includes a cost-of-living allowance if the costs of goods and services is higher in the host country, as well as a housing allowance, so that the employee does not have to sell her U.S. residence. (If the employee does not wish to sell her U.S. residence, she should seek costs for the maintenance of her home while overseas.) Otherwise, the employee should ensure that the package covers the costs associated with the selling and buying of her home, moving and packing costs, and house-hunting trips for her and her spouse. These costs are routinely provided by employers.

In addition to these benefits, the employee should negotiate for reimbursement of costs for educating her children in the host country, where her children may need to attend a private English-language school. If she is moving to a country where living

conditions are uncomfortable or dangerous, she should seek a "hardship allowance" to compensate her and her family for these dangers and discomforts. Some employers will provide cost-of-living allowances to compensate for losses incurred by the employee's spouse in relocating, so she should consider this as well.

The expatriate employee should secure agreement regarding family and/or home leave (specifying the number of trips home per year, and scheduling them where possible), as well as emergency or bereavement trips home, and the payment for such trips (including payment for the travel costs for immediate family members).

The quality of medical treatment varies around the world, so the employee should be mindful of the medical infrastructure of the country to which she will be relocated. If she has concerns about the quality of medical care, she should negotiate for enhanced international medical insurance, and ensure that her health needs (and those of her immediate family) will be met.

Expatriate benefits may subject the employee to further taxation by the U.S. government. Further, the employee may also be subject to taxation in the host country. If she is likely to incur a substantially higher tax liability, she should seek some form of gross-up from the employer to compensate her for this increased tax burden. She should also negotiate for the employer to provide suitable tax and financial planning assistance so that she is not exposed to tax problems at home or abroad.

Finally, the employee should make sure that her agreement covers all costs of repatriation after her assignment ends, regardless of her employment status at that time.

## **8. Assistance For Foreign Nationals**

In addition to carefully considering the panoply of issues set forth above in §§ II (6) and (7), prospective employees who are not U.S. citizens should negotiate for visa and immigration assistance for themselves and immediate family members. Because some visas expire upon termination of employment, the employee should seek a provision that provides her with notice of termination that includes a period of severance, whereby the employee remains on the company payroll, so that she might be able to locate another position (with the employer or elsewhere in the U.S.) and attempt to retain her visa. The employee should attempt to secure a guarantee of post-employment visa renewal assistance from the company.

## **III. NATURE AND SCOPE OF COVENANTS RESTRICTING COMPETITION**

### **A. NON-COMPETITION AGREEMENTS**

Employers try to limit their employees' post-termination ability to compete with the employer by getting the employee to sign covenants prohibiting competition. Such agreements are clearly enforceable while the employee is employed by the employer, and

they also may be enforceable after her employment has ended. The law on enforceability of non-competes varies by state, as does the degree of permitted restrictions. (For example, such provisions are illegal in California, see generally Cal. Bus. & Prof. Code §16600.)

Courts evaluating non-compete agreements seek to balance the employer's interest in protecting its assets against the employee's interest in earning a living. Typically, such agreements must be reasonable under the particular circumstances. The employee's goal in negotiating non-compete agreements is to make them as specific, brief, and geographically narrow as possible. Try to avoid language authorizing punitive sanctions against the employee for purported violations, and consider proposing alternative dispute resolution mechanisms where the employer alleges a breach. See § VI, *infra*. (Note that in most states, courts are more reluctant to enforce non-compete agreements when they are entered into during the course of the employment relationship, absent additional consideration to the employee for her agreement.)

Some general observations about covenants against competition are described below. The employee's attorney should be familiar with the law in her state governing such covenants.

## **1. Interests Protected**

Generally, non-compete agreements seek the protection of three employer interests: (1) trade secrets, (2) confidential information, and (3) "good will."

Regarding "trade secrets," courts weighing claims of breach of covenants not to compete will look at an array of different factors to determine how "secret" the information really is. These factors include the extent to which the information is known outside the business; the extent to which the information is known within the company itself; measures taken by the company to secure the secrecy of the information; and the value of the information to the employer and its competitors.

Courts look at similar factors to decide whether information is "confidential."

Generally, an employer acquires "good will" through its dealings with the company's customers. An employee may be able to argue that the "good will" acquired in dealing with the company's customers was hers, not the employer's, because (for example) she brought pre-existing relationships to the employer.

## **2. Reasonableness of Covenants as to Space and Time**

The employee should try to limit the scope of the non-compete agreement. Courts have held that such covenants must be reasonable as to space and time, so the employee should try to limit the geographic region to (at most) the region in which the employee works for the employer, and to keep the duration of the non-compete agreement as brief as possible. The employee negotiating such covenants should try to secure severance pay

paralleling the period of time she is expected not to compete with the employer. It may be possible for the employee to argue in court that either the space or time frame is (or both are) unreasonable. However, the employee is less likely to be able to argue this successfully if it is part of a comprehensive employment contract negotiated by the employee prior to her hire.

## **B. NON-SOLICITATION CLAUSES**

In addition to attempting to restrict an employee's ability to compete with her employer, companies also try to restrict the employee's recruitment of other corporate employees, and/or the recruitment of the company's clients (although the latter may be considered as part of the "good will" protected by the covenant against competition). Again, the employee should seek to limit the duration of such agreements. Some employers are willing to limit the restriction to apply only to active recruitment, so that coworkers initiating contacts with your client seeking employment are not covered.

## **C. RESTRAINTS ON PROFESSIONALS**

Some states do not allow restrictive covenants to be applied to certain professionals. The employee's attorney should be aware of such prohibitions where she practices. For example, a Massachusetts statute bars imposition of "any restriction" on the right of a physician to practice medicine in a particular geographic area. (Mass. G.L. c. 112, § 12X.) Massachusetts courts have also barred "compensation for competition" clauses that require the payment of money for a physician to compete with a partnership in a particular area. Falmouth Ob-Gyn Assocs. v. Abisla, 417 Mass. 176, 629 N.E.2d 291 (1994).

Counsel also needs to be aware of any ethical constraints that might affect enforceability of restrictive covenants in certain professions, such as attorneys. For example, although Massachusetts has no statutory bar prohibiting restrictions in competition among attorneys, the state's Rule of Professional Conduct 5.6 prohibits restraints against competition by attorneys who withdraw from a partnership. (Massachusetts courts have acknowledged, however, that situations may arise where a firm's losses should be recognized and compensated. See, e.g., Pettingell v. Morrison, Mahoney & Miller, 426 Mass. 253, 258, 687 N.E.2d 1237, 1240 (1997).)

## **IV. TERMINATION OF THE RELATIONSHIP**

### **A. GROUNDS FOR TERMINATION**

The most important provision of the employment contract from the employee's point of view is that which governs the grounds for her termination. This focus can be a tough sell to a client eager to look at the upside of a potential new job. Realistically, your client needs to recognize that the statistical chances of long-term retention of a new executive job are low. Consequently, part of our task as attorneys is to remind clients dazzled by employers' promises of high salary, plentiful stock options, etc., of the

sobering realities of the need for protection from the harsh effects of potential discharge. Most agreements routinely spell out the terms of payment in the event of the employee's death, disability, and retirement. More critical are terms limiting the employer's power to terminate the employee involuntarily. Our goal is to maximize the protections provided by the contract against the arbitrary or unfair terminations that at-will status might otherwise permit.

The employee's attorney should take great care in defining the terms allowing for termination of the employment agreement, both by the employer ("for good cause") and by the employee ("for good reason"). She should also seek to define how both sides can agree to terminate the employment relationship, and what should happen in the event that the company undergoes a change of control.

### **1. "For Good Cause" by Employer**

The employee is best served by limits on the grounds available to the employer for discharge. These terms should be as specific and narrow as possible. Typically, employment contracts allow employers to discharge the employee for "good cause." The employee should seek to define "good cause" as precisely as possible in the employment agreement. "Good cause" can be narrowly defined to include a material breach of the employment agreement by the employee; willful failure to fulfill her duties, or gross negligence by the employee in the performance of her duties (i.e., insubordination, embezzlement, fraud, disclosure of company secrets); and/or serious misconduct not related to the job (e.g., felony conviction).

Frequently the employer will attempt to define "good cause" in simple terms of "breach" or "failure to perform duties." The employee should limit these terms as noted above to secure greater protection against employer caprice. Further, determinations of "good cause" should be tied to objective measures of performance. (See § II(E), *supra*.) Even worse are vague "causes" like "in the employer's discretion" or "lack of performance acceptable to the employer." These scarcely put a dent in the at-will edifice and should be resisted vigorously. The employee should seek to require written notice of termination, including the employer's stated reasons for the termination. The employee should also seek an opportunity to cure the reason for the employer's decision to terminate, and, where applicable, a vehicle to appeal the decision.

### **2. "For Good Reason" by Employee**

While the employee should attempt to craft a definition of "good cause" that is as narrow as possible, the employee should attempt to define "good reason" for her own ability to terminate the employment relationship as broadly as possible. Realistically, the employee should seek to include the following terms in her definition of "good reason": after a certain number of years employed by the employer; upon change in control of the company; upon reduction in the scope of her duties and/or staff; upon the company's assignment of the employee to another region; or upon a change in the employee's work schedule.

Note that a “good reason” provision that is too favorable to the employee, or that doesn’t fit within the IRS guidelines under §409A, could subject severance payments, that might otherwise be exempt from §409A, to the full range of §409A rules.

### **3. By Mutual Agreement**

The employee may want to include a provision in the agreement allowing her to leave the employer upon mutual agreement.

#### **B. EFFECT OF “CHANGE OF CONTROL” OF COMPANY**

Given the frequency at which companies today are routinely bought, sold, and merged, the employee should seek to protect herself from the significant likelihood of job loss due to change of control of the company.

The employment agreement should thus include a definition of "change of control" (i.e., merger and/or acquisition of the company with or by another company, a change in corporate leadership, etc.). It is preferable for the employee to retain a "single trigger" to be able to end her own employment and take advantage of her "golden parachute." She should not have to be actually fired by a new corporate entity to trigger this option. The employer may, however, try to impose a "double trigger" (i.e., change of corporate control, plus discharge), or to limit the time period for the employee to exercise her option to depart upon change of corporate control.

Note that §409A contains its own definition of “change-of-control,” which must be met in order for payment of deferred compensation to be permissible.

### **V. SEVERANCE ISSUES**

In preparing the employment agreement, the employee's attorney should keep her eye on potential severance issues for the employee's eventual departure. Some of these issues have been discussed above (i.e., provisions for accelerated vesting of equity interests, termination of contract for "good cause" or "good reason," change of corporate control, etc.). Other issues are discussed below.

#### **A. AMOUNT AND TYPE OF SEVERANCE**

At the outset, the employee does not necessarily want to have a severance clause in her contract, if the contract specifies a particular term of years. Analytically, if the employee is terminated before the end of the specified term, the employer is liable for the entire remainder of the contract, and should not be limited to any (smaller) severance amount.

That said, there are many employment contracts without a specified period of years, and thus the employee should seek specific terms of severance within the

employment contract itself, especially absent good cause for discharge. In many other cases, even where term contracts are involved, employers will insist that their liability be limited to specified severance amounts in the event of termination.

The employee should attempt to negotiate enhanced severance in case the employer wishes to terminate the employee without "good cause," including language that would reduce or eliminate her obligations under a non-compete agreement. Such an agreement should spell out the terms of enhanced severance to which the employee would be entitled.

Note that certain severance payments which are only available upon involuntary severance (or certain narrowly defined "good reason" terminations) can be exempt from §409A. However, if an exemption is not available, the full range of rules will apply, including the required 6 month payment delay for certain key employees of public companies.

## **B. TRANSITIONAL EXPENSES**

The employee should attempt to insert into the employment contract compensation for expenses associated with the transition out of her employment with the employer. These charges include relocation expenses (including travel costs, losses in real estate value, fees and costs associated with real estate closings, and moving expenses); outplacement services (the contract should specify "enhanced" or "executive" outplacement services); financial, tax, and estate planning; and legal expenses.

Reimbursements that can be deducted as business expenses by the employee, reimbursement for reasonable outplacement expenses, and reasonable moving expenses are exempt from §409A provided that (i) the expenses are incurred by the end of the second year following the year of termination from employment and (ii) reimbursements are paid by the end of the third year following the year of termination from employment. Also, reimbursements for medical expenses incurred during the cobra continuation period are exempt from §409A. All reimbursements for medical expenses that are non-taxable are exempt from §409A. Most other reimbursements will have to comply with §409A requirements.

## **C. NOTICE REQUIRED**

Sometimes an employer will seek to use a "notice" provision to limit the amount it owes the employee on the remainder of the contract. As noted above, the employee should try to avoid establishing a notice period that would limit her recovery of the full benefits of fixed-term contract. On the other hand, the employee may be able to use the notice requirement as a tradeoff: an employee who receives payment during a lengthy notice period (i.e., promising one or more years of payment of salary if terminated by the employer) may be better off than an employee with a fixed-term agreement, as the end of the term approaches.

#### **D. EFFECT OF EARLY EMPLOYER-INITIATED TERMINATION**

The employee should seek to insure that her medical, dental, life, and disability insurance benefits will be continued for the length of the severance period, at the company's expense if possible. It is ordinarily to the employee's benefit to retain employee coverage, and delay the trigger for COBRA coverage, as long as possible. However, some employer plans may not permit continuing "employee" coverage during the severance period.

The employee should seek to spell out the calculation, payment and pro-rating if appropriate of as-yet-unpaid bonuses and commissions effective at the time of separation. It should also be specified that accrued but unused vacation time should be paid out upon termination. Note that some states require this by statute. *E.g.*, Mass. Gen. Laws c. 149, §148. The employee should also seek accelerated vesting (and/or extended exercise periods) for unvested stock, stock options, and other equity compensation. The employee should also specify how she will access deferred compensation packages.

#### **E. POST-TERMINATION OBLIGATIONS**

The employee may want to offer to cooperate or consult in the event of a transition. This may be attractive to the employer (who might want to ensure smooth transitions), and thus may be a useful bargaining chip for the employee.

#### **VI. REMEDIES FOR BREACH**

The agreement should spell out the remedies for any purported breach. These remedies should be mutual. It is frequently useful to implement "notice" language that gives each side an opportunity to explain any alleged breaches and to negotiate before commencing litigation.

The employee may want to include language in her employment agreement seeking alternative dispute resolution in the event of disputes arising over the agreement. Mediation and/or arbitration is likely to be quicker, cheaper, and more private for the departing executive (as well as her former employer). Usually a provision requiring mediation, followed by arbitration if unsuccessful, works best. The language should specify that the neutral be acceptable to both the employee and the employer, and should specify who is responsible for paying for the neutral, what law will govern, and where it will take place. Given the high cost of arbitration, the employee should seek to obtain employer payment of all or most of the costs.

Any ADR provision should address its scope. The employee may want to limit arbitration to disputes under the contract, rather than a broader provision that could be read (or misread) to encompass statutory or tort claims.

The employee should resist employer attempts to insert clauses into the employment agreement establishing a "right to injunction" in the event of a purported breach by the employee. She should also resist attempts to insert "liquidated damages"

provisions into the agreement, which are typically sought by employers for use against employees. Also, because employers may seek attorney fees in the event of an alleged breach by the employee, the employee may want the agreement to state that the parties are responsible for their own attorney fees.