

PRACTICAL OBSERVATIONS ON USE OF EMPLOYMENT AGREEMENTS

by

Terrence H. Murphy*

I. INTRODUCTION

- A. Those responsible for hiring on behalf of an employer face multiple questions. How does an employer ensure the new employee understands the employer's expectations and what the employer will provide? Is confirming these points in a letter to the employee adequate? Does it give the employer enough protection? Is such a letter a contract? Is a formal employment contract a better idea? If it is, how useful are prior employment contracts and their provisions? Is anything in writing really needed?
- B. Some private employers rarely use employment agreements (although perhaps they should); others use employment agreements with almost every employee (which rarely is sensible); still others use what they call a standard employment agreement (which probably is an overused form whose structure, terms and adaption to the specific circumstances is not considered).
- C. This outline addresses some key issues regarding the use of employment agreements, their terms and what should be considered.

II. USE OF EMPLOYMENT AGREEMENTS

- A. Reasons to use an employment agreement include to:
 - 1. provide clarity regarding the employment relationship and the parties' expectations about it;
 - 2. define compensation, benefits and incentive compensation like bonuses and commissions, performance goals and objectives;
 - 3. confirm the status of at-will employment, employment for a specific term or employment on some other basis;

* Terrence H. Murphy
Shareholder
Buchanan Ingersoll & Rooney PC
Pittsburgh, PA

4. define the minimum commitments and obligations for both employer and employee;
 5. set forth separation terms;
 6. for certain executives, sales people, and research and development personnel, provide if needed written assurances to persuade the individual to enter into the employment relationship;
 7. for certain executives, provide change-in-control protections; and
 8. to comply with the written plan requirements of IRC Section 409A.
- B. Reasons not to use an employment agreement:
1. Employment agreements inevitably impose restrictions on what are increasingly fluid jobs and positions with most employers.
 2. Employment agreements restrict flexibility in terminating the employment relationship by requiring “cause,” notice periods or imposing other terms.

III. WHICH EMPLOYEES SHOULD HAVE AN EMPLOYMENT AGREEMENT?

- A. Some employers have the view that all employees should have employment agreements, and virtually every employee in their work forces has an employment agreement. However, this is usually not prudent. Employer use of employment agreements generally should be limited.
- B. Employment agreements as a general rule are appropriate for employees whose departure would damage or limit the employer’s ability to conduct business, for employees who have unique skills, knowledge or abilities, and for employees who would be hard to replace. Employment agreements therefore generally should be reserved for executives like presidents and vice presidents, division heads, other members of upper management, key research and development personnel, information systems personnel and certain highly productive sales personnel. Employment agreements also are appropriate for employees whose compensation arrangements are subject to IRC Section 409A.
- C. Employment agreements usually are not appropriate for mid-level and lower-level employees, and office personnel like receptionists, administrative assistants, accounting clerks and office managers. It generally is preferable for an employer to leave itself the flexibility to terminate these types of employees and if necessary replace them without having to pay a notice period or severance or being bound by an employment agreement’s termination requirements.

IV. OFFER LETTERS

- A. Many employers use letters to extend employment offers and outline the terms of the employment relationship.
- B. Employers often do not realize that offer letters can be the basis for an enforceable agreement, particularly if the employer asks the individual to sign the offer letter to signify acceptance, date and return the letter to the employer.
- C. If an employer uses offer letters, it should avoid assurances of any specific duration of employment or any reference to “cause” grounds for employment termination, and probably should include “at-will” language to assure against having it construed as a contract for a specific term, any disputes and the expenditure of legal fees.

V. ELEMENTS OF AN EMPLOYMENT AGREEMENT

- A. State law governs the construction, interpretation and enforcement of employment agreements. The basic elements of an enforceable contract for services are that the contract designate or identify the place of employment, some term of employment, describe or reference the services the employee will provide and indicate the compensation the employee is to receive.
- B. In general, the terms must be clear enough to be understood and enforced. A written employment agreement will be construed against the drafter and in favor of the party who did not draft it. The employer should avoid use of industry-specific or employer-specific terms so that the agreement can be easily read and understood.
- C. Particular Terms
 - 1. Description of Duties
 - a. Include the name or title of the position and possibly a description of job functions or duties.
 - b. Include language which requires the employee’s best efforts, to focus all of the employee’s time, energy and effort on the employer’s interests during working hours, and to refrain from activities or conduct which would damage or impair the employer’s business.
 - c. It sometimes is appropriate to include the place or location where duties will be performed.
 - d. It may be appropriate to include the reporting relationship unless it is likely to change soon or with frequency.

- e. Include a recitation that the employee will perform the duties of his position and any other duties the employer assigns.

2. Term

- a. Stating or reciting the term of the agreement is critical, whether the agreement indicates employment is at-will, only provides some minimum form of notice prior to termination, or includes more complex provisions.
- b. Whenever an employment agreement is for a fixed term, the parties should indicate what happens at the end of the term – whether the agreement will end, continue with a one-year or other extension, evergreen unless one party provides notice, or continue on some other basis.

3. Compensation

- a. Stating basic salary generally is straight-forward; some employers simply state a minimum basic salary.
- b. Bonus or incentive payments should be addressed. For example, if the employer pays a bonus, the employment agreement should indicate the terms relating to payment, and other relevant criteria. Whether to include performance criteria or a reference to another document with such criteria is a decision on which there is no uniformly correct approach. It is now critical to evaluate compliance with IRC Section 409A for bonus or incentive compensation arrangements.
- c. Commission payments often are a point of dispute. If the requirements for commissions are not spelled out in another document, the employment agreement may be the right place to specify when a commission is earned, how and when it will be paid, whether there is a draw against commissions, whether the employee must pay back unearned draws in the event of employment termination and the effect of employment termination on pending sales.
- d. It often is appropriate to include a provision indicating whether the employee is to be reimbursed for reasonably incurred business expenses and what the employer's requirements are for such reimbursements.
- e. This provision might indicate how and when an employee's salary may be adjusted, either up or down. Often, it is appropriate simply to specify a minimum salary.

4. Benefits

- a. Provisions concerning benefits generally should indicate what benefits the employee will be eligible to receive, provided that the employee satisfies the requirements for coverage pursuant to the employer's benefit plans.
- b. Entitlement or eligibility for stock options, profit sharing plans or pension plans should be identified, and if the employer uses other documents to govern those entitlements, those documents should be identified and it should be specified that they control, not the employment agreement. Again, IRC Section 409A concerns must be addressed.

5. Termination

- a. If an employment relationship is not at-will, then the termination provision must address under what circumstances the employment agreement can be terminated, who can terminate the employment agreement, whether the employee is to receive any form of compensation upon termination, and if the employee is, how much.
- b. Circumstances of termination
 - i. An employment agreement should state that it terminates upon death of the employee and document what payments, if any, will be made to the employee's designated beneficiary or estate.
 - ii. The termination provisions generally should deal with whether or not, and perhaps after what period of time, an employment agreement will terminate in the event of the employee's disability. To comply with the Americans with Disabilities Act, a provision might recite that, in the event of an employee's disability, employment will terminate if the employee cannot perform the essential functions of his or her job for some extended period of time, typically 90 or 120 consecutive days. These kinds of provisions usually are reserved for employees in significant executive, research or product development roles.
 - iii. An employment agreement usually should provide a way for an employee to end the employment relationship without cause or reason. This kind of provision typically states that an employee may terminate the employment relationship without cause upon written notice to the employer – perhaps of 14, 30 or 60 days.

- iv. Employment agreements sometimes provide that an employee may terminate the contract for good reason, such as a substantial change in duties or responsibilities without the employee's consent, a change in the employee's compensation without employee consent, a requirement that the employee relocate or the employer's breach of the contract. These kinds of provisions should not be in every employment agreement. They are more typical in the agreements of employees of significant value and/or where the employer has included or negotiated such a provision to obtain the employee's services. They may raise IRC Section 409A issues.
- v. The employer should include a provision that allows it to terminate without cause or reason, based on advance written notice to the employee. It may be prudent to include a provision that allows the employer to relieve the employee of duties and responsibilities during the notice period and to pay the employee for the notice period rather than have the employee remain in the work place. The duration of this notice period is in effect a substitute for severance and its brevity or length can be a negotiating point if severance becomes an issue at termination or is not otherwise dealt with in the agreement.
- vi. A provision that allows the employer to terminate for "cause" often is critical. The definition of "cause" is what the parties contractually decide upon. Too restrictive a definition can leave the employer where it cannot terminate the employment agreement except for a criminal act, gross negligence or reckless conduct, which can make termination for poor performance virtually impossible. An employer usually should include a provision which provides for termination for "cause" for not only criminal acts, conduct, fraud, misrepresentation, theft or dishonesty, but also factors such as poor performance to be judged in the employer's sole discretion, violation of policies and procedures, and employee breach of the terms of the employment agreement.
- vii. It should be clear what compensation, if any, will be paid upon termination of employment. Setting forth different compensation options, depending on whether the agreement is terminated "with" or "without cause" or based on voluntary resignation is critical to avoid arguments about entitlements. For example, an employment agreement may provide that, if an employee resigns, the

employee will be entitled to receive only compensation earned up to and through the date of employment termination, but if the employer terminates employment without cause, then the employee will receive severance in addition to accrued but unused vacation, bonuses or other incentive compensation to which the employee is entitled (all of which may raise IRC Section 409A issues). Often, where the employer terminates the agreement for “cause,” the employee receives only the amount of compensation earned up to and through the date of termination.

D. Protection of Employer Interests and Property

1. Non-competition covenants may be a realistic means for many employers to ensure that their key employees and key corporate information do not depart for competitors, but courts in most jurisdictions impose a substantial burden on the employer to show that such a restriction, which significantly limits the mobility of employees, is truly justified. Their blanket use usually is not sensible and may limit their enforceability. Other legal approaches to departing employees may be better.
2. Planning Issues
 - a. Addressing what happens when an employee leaves involves employer consideration of the kinds of employees it has, what would happen if employees went to work for the competitors and other concerns that may trigger use of different measures.
 - b. Sometimes an employer has a unique employee whose employment provides special benefits to the employer and whose departure to a new company would immediately confer substantial benefit on that employer, but proving uniqueness is hard. Unique employees may be found in entertainment, science, and sometimes are company founders or key sales personnel.
 - c. Some employees neither perform unique services nor are extraordinary performers, but have customer relationships that are very valuable to the employer. With these employees, the employer’s focus is not so much on the risk of losing the employee to a competitor as on the risk of losing customers, so an agreement that prevents the employee from soliciting specified customers and prospects for a period of time may be what is needed and a non-competition covenant unnecessary.

- d. Sometimes an employee has detailed information about the company's customers. For example, the identities of actual customers and concrete prospects may be a secret (even though not usually). Alternatively, the identities of customers may be readily ascertainable or known, but information about the identities of key decisionmakers of the customer, key provisions of customer contracts, special pricing arrangements or formulations of special products, or specific customer preferences may be critical. In this situation, the focus is not so much on losing the employee as on losing control of customer information, so a strong confidentiality agreement may be the best approach, possibly supplemented by a customer no-solicitation provision or relatively minimal restrictive covenant.
- e. The departure of a key employee who knows the company's business plans or strategy, corporate development plans, or perhaps key research results, can pose substantial risk. In these kinds of situations, it often is impossible for the employee to work for a competitor in certain types of jobs without disclosing the information they have accumulated, so the focus is on preventing loss of information. Thus, a restrictive covenant makes sense, as does a confidentiality agreement.

3. Contract Provisions

- a. Especially if an employer has unique employees, recitals in the employment agreement should be specific to the situation and the agreement should be clear that the employee is difficult to replace. It makes little sense to enter into an agreement with a unique employee that is typical of the contracts of other employees.
- b. Customer no-solicitation agreements, like other post-employment restriction agreements, must be reasonable. Where the effort is to restrict sales personnel or others who have customer relationships, requiring a notice period before any departing employee begins new employment is prudent. Employers should be cautious about trying to prohibit an employee from calling on customers he or she did not service or receive confidential information about because courts are likely to view that as impermissible overreaching. It is better to confine the restriction to customers or active prospects who were the employee's primary responsibility or as to which the employee received significant confidential information. Sometimes these customers can be identified by name on a supplemental schedule.

- c. Many employers use over-inclusive confidentiality agreements that are hard to read and leave departing employees unclear as to what their obligations are. Employers should try to be clear in describing what information is to be kept confidential and include easily understood examples, while explaining that the list is not all inclusive.
- d. No-solicitation provisions restricting solicitation of other employees are usually fairly straightforward. Such provisions typically will be enforced where the employer has developed a skilled staff through training or the requirement of certain credentials.
- e. The drafting of non-competition covenants is a large topic that is complex and constantly changing. The goals of non-competition covenants generally are to protect the employer's assets, goodwill and its relationships with customers and its employees, and well-drafted non-competition covenants can serve those purposes. However, non-competition covenants are governed by state laws, which differ significantly from state to state. For employers operating in several states, a non-competition covenant in an employment agreement may be enforceable in one state and not in another. The limits of this paper do not provide for adequate discussion of this issue, but employers should be certain that any restrictive covenant provisions are reviewed by legal counsel and such provisions should be reviewed periodically to ensure they remain valid and enforceable.

E. Dispute Resolution

- 1. Employers increasingly use arbitration clauses in employment agreements, which are generally found enforceable.

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Terrence H. Murphy
Buchanan Ingersoll & Rooney PC
One Oxford Centre
301 Grant Street, 20th Floor
Pittsburgh, PA 15219-1410
Telephone: 412-392-2044
Fax: 412-562-1041
E-mail: terrence.murphy@bipc.com