

# TRUCKER ♦ HUSS

A PROFESSIONAL CORPORATION



## Anatomy of an Employment Agreement

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## What is an Employment Agreement?

- ✦ Written contract of employment
  - > Signed by employee and employer
  - > From a one-page offer letter to a 50-page agreement
- ✦ Other contracts of employment:
  - > Implied contracts
    - Employee handbook
    - Company memorandum or policies
    - Past practices
  - > Oral contracts
    - At-will employment
    - Statute of fraud generally prohibits oral contract for employment if it cannot be performed within one year

## Employment Agreements

- ✦ Presentation focuses on written employment agreements
- ✦ Written employment agreements may incorporate by reference or override certain implied contracts:
  - > Employee handbook
  - > Employee benefit program
  - > Code of conduct
  - > Employment policies
- ✦ Written employment agreements usually contain provisions to supersede any oral agreements and to prohibit oral modifications

## Purposes of the Employment Agreement

- ✦ Formalize terms of employment
- ✦ Assist in hiring, retaining and motivating employees
- ✦ Ensure employee will stay on during a transition period
- ✦ Focus employee's attention and efforts on business objectives by providing change in control or severance payments
- ✦ Protect company trade secrets or other confidential information
- ✦ Protect against raiding of employees
- ✦ Avoid litigation

## Elements of Employment Agreement

- ✦ Offer & acceptance
- ✦ Term
- ✦ Duties, responsibilities & authority
- ✦ Compensation & benefits
- ✦ Termination of employment and severance
- ✦ Restrictive covenants
- ✦ Representations
- ✦ Clawbacks
- ✦ Arbitration

## Term of Agreement

### ◆ At-will employment

- > Generally, if no term is designated, then the term is at-will
- > Employer and employee can terminate employment at any time, for any non-discriminatory reason and without notice
- > An “at-will” employment agreement can require specified notice before termination or resignation
  - Notice can vary from a short period (15 to 30 days) to a long period (6 months to 1 year)
  - Examples include a “garden leave” or “cooling off period”
  - Can create a “lame duck” term of employment

### ◆ Pros and cons

- > More flexibility to terminate employee
- > Key employee can leave at any time

## Term of Agreement

### ★ Specified period

- > The most common specified period is a period of years

### ★ Reasons for a specified period:

- > Lock up key employee
- > Helpful in recruiting lateral hires
- > Recoup value of a signing bonus

## Term of Agreement

### ♦ Expiration of Term

- > “Drop dead” contract
- > Automatic renewal
  - Evergreen
  - Internal Revenue Code Section 409A issues
    - In an evergreen contract, a change in time or form of payment that is subject to Section 409A may be a violation of Section 409A
- > Renewal upon notice
- > Mutual agreement
- > At-will employment upon expiration of term

## Position

### ♦ Title

- > Position with company
- > Position on board of directors

### ♦ Responsibilities

- > Broad v. narrow description
- > Responsibilities of similar position in similar industry or similar size private or public company
- > Additional responsibilities as assigned by board of directors or other officer(s) to whom employee reports

## Position

### ♦ Exclusive/Best Efforts

- > Devote “all” or “substantially all” business time and best effort to affairs of company
- > Outside activities (other boards, civic and charitable organizations)
  - Broad exception
    - Conflict of interest
    - Do not interfere
  - Listed activities
  - Company approval
  - Required participation
- > Does “best efforts” requirement affect standard for termination for “cause”

## Position

### ♦ Reporting

- > Board of Directors
- > Chairman of the Board
- > CEO
- > CFO
- > Designee?

### ♦ Who is the employer—parent/sub?

### ♦ Office Location

### ♦ Extent of travel expected

## Salary

- ✦ Specified amount (e.g., annual or monthly amount)
- ✦ Generally payable under company payroll practices
- ✦ Increases
  - > Discretion of CEO or Board of Directors
    - Good faith
    - Reasonable compensation (directors have fiduciary duties to shareholders)
  - > Fixed amount, COLA, percentage
    - ISS classifies multi-year guaranteed increases as a poor pay practice

## Limited Tax Deductions on Compensation

### ★ IRC Section 162(m)

- > For public companies, compensation deduction is limited to \$1,000,000
- > Applies to CEO and other 3 highest paid officers (excluding CFO)
  - The IRS definition of “covered employee” does not include an executive officer who is the principal financial officer or anyone who acts in that capacity unless such person (x) is also serving as the principal executive officer as of the end of the taxable year, or (y) also holds another executive officer position that is one of the three most highly compensated executive officers of the company for the taxable year.
- > Additional compensation can be paid under “performance-based compensation” exception under Section 162(m)

### ★ TARP restrictions

## Bonuses

### ✦ Signing bonuses

- > Generally to compensate for equity or other compensation that lateral hire is forfeiting or relocation expenses
- > Repayment if resign or terminated for cause prior to end of term of agreement

### ✦ Cash incentive bonuses

- > Guaranteed
  - Generally only applies to initial years as assurance for a lateral hire
  - Does not comply with Section 162(m)
  - Multi-year guaranteed bonuses are an ISS poor pay practice
- > Discretionary Bonuses
  - Greatest employer flexibility
  - Discretion to increase does not comply with Section 162(m)
  - Issue for deferring that amount to a deferred compensation plan

## Bonuses

### ✦ Cash incentive bonus (cont)

#### > Performance-based bonuses

- Smaller companies may set forth the performance criteria in the employment agreement
- Larger and public companies generally provide bonuses under terms of company incentive plan
  - May be exempt from Section 162(m) (discussed later)
  - Employment Agreement can provide that employee will receive bonus approved by company for employees in similar position
  - For executive officers, amount of bonus may be determined as a reasonable bonus consistent with bonuses paid to persons in a similar position at peer group companies or at a percentile of the bonuses paid to persons in a similar position at peer group companies

## Bonuses

### ★ Cash incentive bonus (cont)

#### > Short-term incentive bonus (i.e., annual bonus)

- To be exempt from Section 409A, even a short-term incentive bonus must be paid within short-term deferral rule under Section 409A
- The short-term deferral rules states that the payment must be made or included in the employee's income within 2 ½ months of the end of the employee's or employer's taxable year in which the compensation is no longer subject to a substantial risk of forfeiture
- Best practice is to state that short-term incentive bonuses will be paid within the short-term deferral period

## Bonuses

### ♦ Cash incentive bonus (cont)

#### > Long-term incentive bonus

- Must be structured to be exempt or to comply with Section 409A
  - If the employee is required to remain employed until the end of the performance period, then payment can be made within short-term deferral period after end of performance period and be exempt from Section 409A
  - Otherwise, the employment agreement or incentive plan must comply with documentary and operation requirements of Section 409A
  - If the incentive compensation is paid based on a plan that is incorporated by reference, check that the plan complies or is exempt from Section 409A

## Bonuses

### ✦ Cash incentive bonus (cont)

#### > Prorated bonuses

- Death
- Disability
- Change in control
- Retirement

#### > Section 409A Issues

- If a long-term incentive bonus requires the employee to remain employed until the end of the performance period, but provides for a pro rated award upon change in control or retirement, then the payment may not be paid within the short-term deferral rule and the incentive payment must be designed to comply with Section 409A

## Bonuses

- > Section 162(m) issues
  - Pursuant to IRS guidance, compensation payable for performance periods beginning after January 1, 2009 or paid under employment agreements entered into after February 21, 2008 (or that are renewed or extended after that date, including automatic renewals or extensions) will not qualify as performance-based if it may be paid without regard to whether the performance goals are met when the executive retires, is involuntarily terminated without cause, or terminates employment for good reason. This rule applies without regard to whether any of these events actually occur or the performance goals are in fact attained; the mere presence of the provision disqualifies the arrangement.

## Equity Based Compensation

- ✦ Initial employment agreement may set out the size, form and vesting of an initial grant of equity compensation
- ✦ Equity grants may need to comply with Section 162(m), Rule 16b-3 of the Securities and Exchange Act of 1934, NYSE or NASDAQ rules, and ISO rules
- ✦ Review terms of equity compensation plan
  - > Take care not to “promise” a grant of a certain size, form, or value if it has not been approved under terms of the plan
  - > Generally, the company agrees to “recommend” to board or compensation committee a certain grant
  - > Do not grant ISO in “pre-employment” period

## Deferred Compensation

- ✦ Qualified and non-qualified deferred compensation is usually provided through a separate plan
  - > Tax-qualified plans
    - Traditional defined benefit pension plans
    - Defined contribution plan (such as a 401(k) plan)
  - > Non-qualified deferred compensation plans
    - SERP
    - Deferred compensation plan
    - Excess benefit plan
- ✦ However, the employment agreement may set out that the employer will establish the plan and set out the contribution amounts or fixed benefits that will be provided under the plan

## Clawbacks

- ♦ Breach of employment agreement or other agreements (such as non-compete or confidentiality)
- ♦ Section 304 of the Sarbanes-Oxley Act of 2002
- ♦ TARP
- ♦ Frank-Dodd

## IRC Section 162(m)

- ★ Performance-based compensation exception to \$1,000,000 compensation deduction limit
- ★ Compensation paid upon completion of
  - > Pre-established performance goals
    - Performance goals must be set forth in writing
    - 90-days after the commencement of the performance period
    - Objective (no discretion to increase amount paid)
  - > Set by a compensation committee constituting two or more outside directors
  - > Compensation committee must certify in writing that the performance goals were satisfied

## Health and Welfare Benefits

- ★ Generally provided in separate plan documents and generally entitled to same benefits as employees in similar position
- ★ However, employment agreement may provide for additional or increased benefits under the health and welfare plans
  - > Beware of discriminatory benefits under IRC section 105(h)
  - > If discriminatory health care benefits are provided to highly compensated employees (either eligibility or actual benefits) then a portion of the benefits received (not just the premiums) are taxable income to the employee.

## Perquisites

### ★ Other Compensation

- > Expense account
- > Spouse travel
- > Club membership

### ★ Hot button issues with ISS

- > ISS considers it a poor pay practice --  
“reimbursement of taxes or perquisites or other payments (e.g., personal use of corporate air craft or corporate life insurance.)”

### ★ Again, watch-out for Section 409A issues

## Termination of Employment

- ★ When can the company terminate employee and pay no severance?
  - > Generally referred to as termination for “cause.”
- ★ When can the employee terminate employment and still receive severance?
  - > Generally referred to as termination with “good reason” or “constructive termination.”
- ★ What other events may trigger severance payments?
  - > Change in control, death or disability

# Termination of Employment for Cause

## ♦ Cause

- > Unless defined, the employer (or a court) has discretion to determine if an action or inaction of the employee constitutes cause
- > Battle of definitions
  - Commission v. conviction (or plea of guilty or nolo contendere) of a crime
  - Fraud, embezzlement, theft and dishonesty
  - Willful misconduct
  - Substance abuse
  - Gross malfeasance or nonfeasance
  - Failure to follow directions
  - Negligence
  - Breach of contract – confidentiality or non-compete agreement
  - Code of conduct
- > Materiality or adverse affect on company
- > Curability

# Termination of Employment for Good Reason

## ♦ Good Reason

- > One of the reasons to carefully draft the elements of the employment agreement and the employee's position and responsibility is because those elements may serve as grounds for the employee to terminate employment for good reason
- > Common Elements:
  - Material reduction in base compensation or failure to provide a raise
  - Material demotion in title, authority, duties or responsibilities
  - Significant relocation of geographic workplace
  - Failure to elect to board of directors
  - Breach of employment agreement
  - Change in who employee reports to
- > Time period to provide notice of good reason
- > Time period to cure

# Termination of Employment for Good Reason

## ★ Good Reason (cont)

### > Section 409A safe-harbor

- Material diminution in employee's base compensation
- Material diminution in employee's authority, duties or responsibilities
- Material diminution in authority, duties or responsibilities of officer to whom employee reports or change from reporting directly to the board to a corporate officer
- Material diminution in budget over which employee retains authority
- Material change in geographic location of office
- Material breach of employment agreement by employer
- Employee must give 90 days notice of event and employer must have 30 days to cure

## Termination of Employment for Good Reason

- ♦ Severance Payments
- ♦ Enhanced Severance Payments
- ♦ Releases

## Disability

- ★ Definition of disability
  - > Long-term disability policy
  - > Section 409A
  - > IRC Section 22(e)
  - > Social Security disability insurance
- ★ Determination of disability
  - > Company
  - > Insurance carrier
  - > Social Security Administration
- ★ What is it being used for?

## Change in Control

- ◆ Definition of change in control
  - > Stock acquisition
  - > Sale of all or substantially all assets of the company
  - > Merger
  - > Change in majority of board of directors
- ◆ Consistency of definition in employment agreement, equity awards and deferred compensation plans
- ◆ Consider the 409A rules

## Change in Control

- ✦ Single trigger – Payment immediately upon a change in control
  - > ISS considers single triggers to be a poor pay practice
- ✦ Double trigger – Payment if employment is terminated within a set period of time after a change in control
  - > Generally triggered upon termination without cause or resignation for good reason
- ✦ Window period – Walk away right for a certain period after change in control
- ✦ Generally should be triggered on “consummation” not execution of the transaction agreement

## Severance Benefits

- ✦ The amount and types of severance payments and benefits vary from company to company based on the company's compensation philosophies. Some examples:
  - > Base salary is the most common type of severance and, depending on the employee's position, may be a number of months of base salary or a multiple of base salary
  - > Bonus
    - Target level? Does Section 162(m) apply?
    - Based on previous year or years?
  - > Accelerated vesting of equity compensation
  - > Continued health coverage
  - > Other welfare benefits
  - > Outplacement

## Severance Benefits

- ★ The timing of severance benefits also varies substantially from company to company
  - > Lump sum v. periodic payments
  - > With periodic payments over a specified term, the employer has the ability to cut off payments if the employee breaches the company's confidentiality, non-solicitation or non-compete agreements with employee

## Section 409A

### ♦ Short-term deferral exemption

- > If severance payments or benefits are paid or included in the employee's income within the short-term deferral rule, then the payments are exempt from Section 409A
- > It is best practice to state expressly that the payments will be made within the short-term deferral rule even if the agreement states that payments will be made as soon as practicable or use other similar terms

## Section 409A

### ♦ Limited separation pay exemption from Section 409A

- > The plan only provides for separation pay upon an involuntary termination or pursuant to a window program; and
- > Severance pay does not exceed 2x the lesser of:
  - The employee's annualized compensation based on the annual rate of pay for services provided to the employer for the taxable year preceding the separation; or
  - The maximum amount that may be taken into account under a qualified plan under Code § 401(a)(17) for the current year (for 2011, \$245,000); and
- > All payments are made by the end of the second taxable year of the employee following the year in which the separation occurs

## Section 409A

- ★ Non-taxable benefits exemption
  - > Bona fide vacation leave, sick leave, compensatory time, disability pay, death benefits and medical benefits that are non-taxable are not non-qualified deferred compensation
  - > Medical benefits paid during COBRA continuation period are generally exempt from Section 409A
  - > Watch-out for Section 105(h) taxable benefits
- ★ Stacking exemptions

## Mitigation or Offset

- ✦ Generally at common law, if the employer breaches the agreement, the employee is entitled to damages for the breach, but subject to the employee's obligation to seek employment to mitigate the damages
- ✦ Typically in an employment agreement, there is no obligation to mitigate, but severance payments and benefits may be forfeited if the employee finds new employment
  - > Minimum severance benefits may also be guaranteed
  - > Offset provisions should be carefully drafted to comply with Section 409A

## General Releases

- ✦ The payment of severance benefits is usually conditioned on the employee signing a general release of claims
- ✦ Section 409A issues. If severance payments are contingent on the employee's execution of a general release, the short-term deferral rule may not apply if the agreement does not include a deadline for signing the release
  - > Absent a deadline that meets the parameters of the short-term deferral rule, there is a possibility that the payment could be paid outside the deadlines required by the rule

## General Releases

- ✦ Examples of provisions in a general release that could violate Section 409A include:
  - > Payment will be made within 30 days after the employee's execution of the general release
    - This is too open ended—it is possible that payment will be made after the short-term deferral deadline
  - > Employee must execute the release within 30 days of presentation of the release
    - Again, this is too open ended

## Disability or Death Benefits

- ✦ There are many ways to provide disability or death benefits
  - > Disability or death can be a trigger for all or part of the severance payments due
    - If payments are made outside of the short-term deferral, then the payments must be designed to comply with Section 409A
  - > Separate disability or death benefits can be provided
    - Instead of severance, benefits under the company's long-term disability plan can be provided
    - Instead of severance, death benefits can be provided by the company or through life insurance
      - Generally, these disability and death benefits are not subject to Section 409A
      - However, these benefits may also be used to offset severance payments, in which case careful drafting is required to comply with the Section 409A offset provisions

## Golden Parachute Payments

- ✦ IRC Sections 280G and 4999 provide that if payment of compensation or benefits is
  - > Contingent on a change in control and
  - > Exceeds of 3x average base amount over prior 5 years, then
  - > The corporation loses its tax deduction for the compensation paid, and
  - > The employee pays a 20% excise tax on the amount of compensation in excess of 1x average base amount over prior 5 years

## Golden Parachute Payments

- ✦ In the event Section 280G and 4999 are triggered, the employment agreement should address what will happen
  - > Cutback
  - > Best after-tax payment
  - > Full tax gross up
    - ISS considers this a poor pay practice

## Non-Competition

- ✦ Governed by state law
- ✦ Generally must be reasonable
  - > Scope of business
  - > Geographic coverage
  - > Time period
  - > Generally non-compete provisions are prohibited in California, with limited exceptions
- ✦ Requires consideration
  - > Continued employment
  - > Enhanced severance payments
- ✦ Injunctive/equitable relief
- ✦ Separate company policy may be appropriate to not have individually negotiated non-competition provisions

## Non-Solicitation and Non-Interference

- ✦ Governed by state law
- ✦ Employees and customers
  - > Current, former and/or prospective
  - > Geographical area or entire company
- ✦ Time period
  - > During employment
  - > Number of years after employment
- ✦ Enforceable in California

## Confidentiality

- ✦ Trade Secrets
- ✦ Customer lists
- ✦ Scope of authority to disclose during employment
- ✦ Prohibition from disclosing after employment
  - > Exceptions for information that becomes public, information required to disclose by law, information disclosed to employee after employment
- ✦ Return of all copies of confidential information
- ✦ Injunction/equitable relief

## Representations and Covenants

- ✦ No conflict with prior agreements
- ✦ Not subject to non-compete or non-solicitation
- ✦ Duly licensed and in good standing (professionals) and not subject to any disciplinary action
- ✦ No pending or threatened litigation or action by regulatory or licensing authority
- ✦ Will not disclose confidential information from prior employer with out consent

## Other Provisions

- ♦ Arbitration
- ♦ Non-Disparagement
- ♦ Indemnification
- ♦ Legal Fees
- ♦ Choice of Law
- ♦ Assignment

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