

EXECUTIVE ISSUES AND CONCERNS

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EXECUTIVE ISSUES AND CONCERNS

I. Introduction

- A. This outline will address, on a cursory level, certain issues and practical pointers and concerns for executives in our present time. This discussion will be based both from the executive's point of view, and where appropriate, from the employer's perspective as well.
- B. From the Executive's perspective, the days of remaining with and having undivided loyalty to your employer until you retire are long gone. With the U.S. economy in a severe recession, corporate reductions in force and executive terminations are on the rise. Moreover, bankruptcies, corporate restructuring and increased accountability for officers and directors are now a common occurrence. Unfortunately a top notch executive can lose his or her position with a company without warning, and in many cases, without justification. From an employer's perspective this is a time when a top notch executive must perform. The very survival of a company may depend upon the skills and adaptability of the executive in a very difficult economic environment.
- C. Executive level employees need to exercise great care when beginning employment with a new employer. Contractual protections in today's marketplace are important and necessary. A well drafted agreement (which can even be in the form of a brief letter agreement) is more necessary now for the protection of the executive. When negotiating their employment agreement, executives need to carefully define their compensation expectations and agreements, and also anticipate and prepare for their eventual separation from their employer.
- D. An executive and the prospective employer need to realistically assess the relative strengths and/or weaknesses of their bargaining positions. It is critical for an executive to understand this before determining what to ask for and what to expect when negotiating an executive employment agreement. Simply put, an executive must be able to realistically assess his or her negotiating leverage.
- E. Many employers want the C-level executive (particularly at the CEO and President level) to be fully committed to the business and may even require or strongly encourage the executive to have "skin in the game" as a precondition to employment. Top executives need to be able to carefully evaluate not only employment related issues but also investment issues if a substantial sum of money will be invested in the company.
- F. An executive needs to carefully and realistically think about his or her exit strategy when commencing employment and plan accordingly. In many

instances, it would be prudent for the executive to anticipate an exit in no more than a 3-5 year time period.

- G. An executive who reports to the Board of Directors needs to exercise care when providing any written report to the Board, especially in the case of revenue and cost projections, budgets, etc. If the projections or budgets later fail to meet actual operating results, they may be used against the executive at a later date to justify a "for cause" termination.
- H. Recently enacted tax laws and economic recovery laws are impacting the structuring of executive compensation agreements (see further discussion herein).

II. General Employment Issues

- A. "At-will" relationship versus contract employee
- B. Summary of "at-will" relationship

COMMENT: Texas and many other states are "at-will" employment states. As such, the employment relationship between the employer and the employee can generally be terminated at any time, for any reason, or for no reason. Either the employer or the employee may terminate the relationship.

COMMENT: In a handful of states (*e.g.* Alabama, Alaska, Arizona, California, Delaware, Idaho, Montana, Nevada, Utah, Wisconsin and Wyoming), the law imposes a covenant of good faith and fair dealing on employers that is essentially read into every employment relationship. Thus, every termination is subject to something along the lines of a "just cause" standard. Texas and most states reject this exception, recognizing that judicial oversight into the motives behind employment decisions is an overwhelming and inefficient undertaking.

COMMENT: The employment-at-will relationship may be modified by an employment contract. If a contractual relationship exists, termination and other defined terms of employment will be governed by the terms and conditions of the contract.

C. Means in which an employment contract may arise

1. Express written agreement (includes both detailed contracts and simple offer letters)
2. Conduct of the parties
3. Handbook or other policy procedures

COMMENT: An employment contract may either arise by express terms or by indirect actions. As may commonly occur, the employee and the employer may set forth their employment relationship in a written instrument. The written instrument may be very simple, setting forth only wages, employment length and similar terms, or it may be very detailed and specific, identifying a wide spectrum of issues, such as duties, benefits, termination for cause by employer or employee, change of control situations and restrictive covenants after termination (e.g., non-competition, non-solicitation, non-disclosure, etc.)

COMMENT: An employment contract may also indirectly arise. If the employer consistently treats its executives in a particular manner (e.g., always giving one year severance pay upon termination), this course of conduct may create an obligation upon the employer with regard to future terminations of other executives. As another example, if the employer has an employee handbook or personnel manual that details a graduated scale of discipline (e.g., first oral warning, then written warning, next suspension with termination following), the employer may be required to follow each discipline step prior to termination. Some courts have discussed that it may be discriminatory for an employer to leap to the termination phase without going through each established discipline step. Accordingly, the actual language utilized in such handbooks may have significant ramifications.

D. Benefits to Employee of Employment Contract

COMMENT: An employment contract can be very beneficial to an executive employee. It is highly recommended to have such an agreement in today's job market environment for proper protection of an executive. Security can be obtained through an established employment term. If

the executive employee is terminated, the contract may require the employer to continue paying salary and other benefits throughout the term and/or thereafter in the form of severance pay. The contract may also confirm the employer's obligations to pay performance bonuses (or a prorata portion of the bonuses) if the executive is terminated before the end of the term or applicable operating year.

1. Limitation of termination "for cause"

COMMENT: The employment contract can also modify the at-will relationship by limiting the employer's termination rights to "cause." In other words, the employer cannot terminate the relationship without reason. The employer's termination rights can be limited to the specific "for cause" reasons set forth in the agreement (e.g., conviction of a felony, embezzlement, failure to achieve sales/revenue milestones, etc.) "Financial cause" provisions need very careful attention as the mere failure to meet numbers can lead to an executive's dismissal "with cause" if an agreement so provides (even if the failure to attain such goal, was beyond the executive's control – e.g., employee strikes, material cost increases because of hurricanes or other natural catastrophes, legislation limiting business activity, or increasing costs, etc.) The executive level employee will want to define the "for cause" items as narrowly as possible. In some instances where the executive has an exceptionally strong bargaining position, it is possible to eliminate the "for cause" termination provision such that the executive can only be terminated without cause (with severance benefits for the executive payable upon such termination). The employer, on the other hand, will want the "cause" termination right to be as broad as possible. Generally, if the employer asserts the occurrence of a "for cause" event, the executive will desire written notice prior to the effective date of termination with cure rights where appropriate. In addition, in certain circumstances, the executive may want the opportunity to meet with the decision makers (e.g., the Board of Directors) to provide an accurate understanding of the facts and circumstances leading to this action. The consequences to the termination "for cause" are usually termination of pay, with no severance or continuing benefits. In the case of a "financial cause" termination, there may be room for

the executive to negotiate a limited severance and/or benefit continuation.

COMMENT: The executive may also need to describe circumstances giving the executive the right to terminate for "good reason." These circumstances may include a material demotion of job duties or responsibilities (arising "without cause"), a material change in the location for performance of services, or possibly a "change of control." Upon a termination by the executive for "good reason," the executive will receive a predefined severance, set forth in the contract.

2. Define employee benefits

COMMENT: The employment contract should define the specific benefits to be provided executive employees during their employment. This may include common benefits such as vacation, medical coverage, automobile allowance and club memberships, but may also include incentive bonuses, stock options, stock appreciation rights, etc. In addition, the benefits may include post-termination rights (e.g., continued medical coverage, severance obligations of the employer, outplacement assistance, or salary continuation upon disability or death, etc.)

E. What the Employer Typically Wants in the Employment Documents

1. Identify employment terms for employee to remain with the company or be subject to certain restrictions

COMMENT: Although many employers prefer not to have employment contracts, a written contract is an opportunity for the employer to succinctly state its relationship with the employee. The employee's duties can be specifically defined. Further, the employer can require that the executive devote his or her full energies and services to the employer. Moreover, the employer can set performance milestones for the executive's expected performance. If the executive fails to achieve certain pre-determined milestones, and is subsequently terminated, the executive may not have a strong position to contest the decision.

2. Specify in detail all non-competition and/or confidentiality/trade secret restrictions, and identify development ownership issues for the executive, both during the term of employment and thereafter

COMMENT: One of the most important benefits to be obtained by an employer through a written contract may be the inclusion of restrictive covenants, either on a stand alone contract or within an employment agreement. If the executive will be working in an area involving trade secrets, the employer, at the time of initiating employment, will likely want non-competition, non-solicitation, anti-raiding and confidentiality provisions. Such clauses can legally prevent the executive from using the employer to obtain industry knowledge and contacts, and then go into direct competition with the employer. The confidentiality clause can prohibit the executive from taking confidential and trade secret information and using it or disclosing it, either during employment or for a reasonable period after termination. The non-solicitation and anti-raiding provisions can protect not only customers of the employer, but also the employer's valuable employees.

COMMENT: An executive needs to be very careful about not inadvertently giving away a preexisting relationship that the executive cultivated prior to accepting the new position. For example, assume that an executive is hired by a new company because of his or her preexisting relationship with an extremely large customer. If the executive is required to sign a non-solicitation and non-compete agreement, the executive may not be able to retain this critical relationship, and the executive may be prevented from taking this large customer to a future new employer (a potential competitor of the former employer) in the event of termination.

COMMENT: If the executive is in a position of creative development, the executive needs to be cautious of "invention" or "development" clauses commonly found in employment agreements. Typically, the more common clauses of this kind confirm that all inventions and developments of the employee, while employed by the company, will be owned by the company. Generally, these developments are more tangibly identified (e.g., software code, product formulae developed, etc.) However, those developments may also include

business concepts, development ideas or other business strategies created by the executive. If the identified concepts may be used generically with other employers (e.g., without jeopardizing the trade secrets of the company), the executive should seriously consider the need to retain the right to use of the concepts and document the arrangement with the employer so as to avoid any potential misunderstanding.

3. **Releases.** The employer may require the future execution of a release agreement in an employment agreement as a pre-condition to receiving any severance. Executives should exercise great care before agreeing to sign a one-sided release in favor of the employer. The executive's receipt of severance is not always conditioned upon execution of a release agreement. Yet, the employer may attempt to secure such a release before paying severance benefits. If signing a release is a contractual precondition to receiving severance pay, it may be advisable to negotiate the actual form of the release at the time the employment agreement is signed. The executive will want the release to be mutual and will need to draft the appropriate carve-outs from the release to be provided to the employer (e.g., the survival of the obligation of the company to indemnify the executive for his or her role as a corporate officer). The employer will want to make sure the executive does not cause financial harm to the company and will often precondition the severance payments upon compliance with certain agreements set forth in the separation agreement.
4. **"Skin in the Game."** Many employers want the executive to invest in the company. (See discussion below in Section VI.) Additional documentation will likely need to be prepared to protect the executive's equity investment.

III. Termination of Employment

COMMENT: The ending of an employment relationship is a common occurrence and should be anticipated by the executive when starting a new position with a company and carefully planned for when negotiating an executive employment agreement. There are numerous factors which may lead to the decision to terminate employment: economic downturn, consolidation of business operations, failure to achieve satisfactory financial results, strategic acquisitions, spin-off of business lines and, of course, unsatisfactory job performance. Another common factor is personal chemistry. This factor should never be underestimated. Even though an executive may be achieving

all previously established business goals, if he or she does not have a good working relationship with the CEO or the Board of Directors, the executive may be terminated to make way for a person who has a proven track record that fits the chemistry needs of the company.

In the instances where a company is being sold, merged or some other significant corporate transaction is occurring, the executive may or may not be retained. If the executive is retained, it is very important to anticipate that the executive may have a relatively short employment life expectancy of no more than 12-24 months. Prudent planning is vital in these instances.

In addition, as a result of the increased awareness of the personal exposure of many directors, there is more of a willingness today for the Board of Directors to sacrifice a top level executive to save or insulate the directors from liability.

A. Employee Perspective

1. It is of paramount importance for an executive to preserve his or her good name and reputation in the event of a job termination.
2. Notice and opportunity to cure may be required prior to an employer exercising its termination rights.
3. A contract may allow for certain opportunities for an executive employee to meet with the decision maker(s) to discuss reasons of termination prior to determination of "cause."

COMMENT: From the executive's perspective, you can and should prepare in advance for a potential termination. As noted above, in many instances an executive's termination is unrelated to job performance. Instead, the decision may be merely the result of a clash of personalities, or the executive may have been terminated as a sacrificial lamb to insulate a director from potential blame. However, by carefully planning before beginning employment, an executive may establish clear parameters in the contract to assist his or her graceful and painless transition into a new position.

COMMENT: An executive employment contract should provide for severance benefits upon termination, including compensation and executive outplacement assistance. The amount of severance an executive may receive is

dependent upon the executive's position and bargaining strength. A severance package of one or two years' base salary continuation with twelve months outplacement is not uncommon for key executive positions. With large companies, some executives possess the negotiating leverage to obtain even greater severance benefits. Severance will provide a financial bridge leading into the executive's new job. Further, notice may be required before the termination is effective. If, for example, a 90 day notice is required by the employer, the executive may have sufficient opportunity to locate a new job prior to the effective date of termination from the old job.

COMMENT: Termination "without cause" may be structured in a way to accelerate non-vested options. Often, compensation packages heavily weighted with options may be illusory if these are non-vested options that are revoked upon termination.

COMMENT: If the contract contains a non-competition clause, the executive may be able to narrowly define the restricted business line or prohibited business operations to enable him or her to readily find new employment without directly competing with the previous employer. In addition to the narrow restrictive covenant, the executive should attempt to carve-out specifically permitted non-competitive business lines or industry areas that the executive can work within upon termination. If the future employment by the executive in these areas is not a financial detriment to the employer, the employer may not object to such a carve-out.

COMMENTS: Tax Issues. Effective January 1, 2005, Congress passed new legislation which substantially impacted the taxation of deferred compensation. If not structured properly, Section 409A of the Internal Revenue Code can cause acceleration of the recognition into income of the deferred compensation and a penalty tax of 20% and interest (accruing from the date of deferral on the amount of tax) upon the deferred compensation. Section 409A impacts not only traditional deferred compensation, but also severance pay, stock options and stock appreciation rights and change of control payments. When negotiating severance pay in the initial executive employment agreement, both the

employer and the executive must be mindful of meeting the requirements of Section 409A. While all of the technical requirements of Section 409A are not explained here, the essential elements of compliance for severance arrangements are that the terms be negotiated up front and be payable no earlier than termination of employment, and be payable in either the same year as termination of employment (or no later than 2½ months after that year) or pursuant to a fixed schedule beginning after termination of employment. The impact of Section 409A on stock options and stock appreciation rights is discussed further in *Tax Issues* (Section V.C. below). In structuring any deferred compensation or separation pay, these Regulations must be consulted.

B. Employer Perspective

1. If "at-will," no cause is necessary, no notice is required and no severance is required.
2. Document "cause," if any, upon termination. Discrimination should not play any part of the decision, whether sex, race, disability or age. Retaliation should also not be the basis for any termination decision (e.g., terminating an employee because the employee identified or raised an accounting irregularity or filed a discrimination complaint).

COMMENT: Whatever the reason leading to the termination, the employer should handle the decision in a lawful and appropriate manner. In general terms, if the relationship is "at-will," no reason is necessary, no notice is required and there are no severance obligations unless an agreement or company policy provides otherwise. However, care should be given to ensure that all employees are treated consistently.

COMMENT: Discrimination should not play any part in the employer's decision to fire an executive employee. As an example, if the decision to fire was made 95% because of lack of performance and 5% because the employee is disabled, and the employer did not want to make accommodations to enable the employee's continued work, this action is unlawful and the employer may find itself in a lawsuit. Unlawful discrimination may appear from decisions made relating to the employee's sex, race, age, religious

belief, veteran's status or disability (or other characteristics protected by applicable federal or state laws).

COMMENT: If the employment agreement requires the employer to pay severance payments to the terminated executive employee over a time period, the employer may want any non-compete and/or non-solicitation restriction periods to extend to no less than the period of time payments are being made. Upon any breach of the restrictive covenants by the executive, the contract terms should state that the payments should stop (and the contract may require the executive to reimburse the company for any payments previously made). The employer will not want the terminated executive competing with or soliciting customers from the employer while the employer is still paying the terminated executive.

IV. Separation Agreements

- A. Often times, the executive and the employer will want to enter into a separation agreement upon the executive's termination. This agreement may be subject to negotiation. From both the executive's and employer's perspective, important issues may arise concerning severance payments, restrictive covenants, releases, indemnity obligations, future cooperation and further provisions that will require great care in drafting.

COMMENT: Before agreeing to a separation agreement, the executive needs to carefully consider what he or she may be contractually entitled to receive. Additionally, the executive may want to consider what negotiating leverage he or she may have in structuring an acceptable agreement. For example, an executive who is a critical witness in a large lawsuit may be able to negotiate a generous severance package, even if the executive was not contractually entitled to receive any severance payments. Or, if the executive has a strong relationship with a large company customer, the company may need to ensure a smooth transition of the executive out of the relationship without jeopardizing the customer.

- B. At times, disgorgement provisions require the executive to pay back to the company all sums received, and forfeit all future sums required to be paid

in the event of a default by the executive. These provisions need to be carefully reviewed.

- C. Unilateral general releases in favor of the employer are common in separation agreements. The executive employee may want to explore whether he or she can negotiate a mutual release. If the employer agrees to provide this, the employer may want to carve out an exception for such bad acts as fraud or embezzlement.
 - D. Non-disparagement clauses are common. In general, even though each party has common law rights against defamation, it is easier to enforce an express contractual provision in this area. Employers are usually resistant to broad non-disparagement clauses because it is difficult to control an entire workforce. However, in many instances, the executive can receive the necessary protection if the non-disparagement clause will bind the employer and its top management.
 - E. As stated above, in order to avoid the 20% penalty tax and accrual of interest on the tax from the date of deferral, Section 409A of the Internal Revenue Code must be considered when negotiating severance pay in connection with a separation agreement. If the severance pay is negotiated at the time of an involuntary separation, rather than up front when the employment agreement is signed, then the negotiations must be bona fide and the amounts must be paid either in a lump sum in the year of separation (or no later than 2½ months after that year) or pursuant to a fixed schedule. Separation pay negotiated at the time of a voluntary separation cannot be deferred beyond the year of separation or 2½ months after that year.
- V. Stock Options and Other Compensation Issues
- A. Bonuses. Bonuses, based on performance, are often a key element in any employment agreement with executive employees. The possibility of a cash bonus provides an extra incentive to the executive employee to work toward the success of the employer. While bonuses can be based upon an almost infinite variety of methods and/or formulas, most often we see the following:
 - 1. Discretionary Bonuses. Under this approach, the employer has no obligation to pay any particular amount of bonus to the executive employee, but rather the total discretion to pay the executive employee an amount of bonus at the end of the year (or other measurement period) is based on the employer's own determination of the executive's performance. From the employer's perspective, a discretionary bonus system is favorable in that the employer is not locked in to pay any particular amount

of bonus, but can instead tailor each bonus to the particular circumstances then at hand. Generally, from the executive's perspective, a totally discretionary bonus may limit the incentive to produce particular results and can cause uncertainty as to whether the employer will be fair in rewarding the executive employee for his or her efforts.

2. Formula Bonuses. Under this approach, the bonus is based on objective formulas or criteria. Often bonuses are based on increases in corporate earnings after the executive employee comes aboard, with such corporate earnings measured in one of a variety of ways—absolute net earnings, net earnings before deduction for interest, taxes, depreciation or amortization (EBITDA) or variations on the EBITDA formula. Bonuses based on corporate earnings are particularly suitable for CEOs, CFOs and other executive employees whose efforts can be seen to translate directly to the bottom line. Executive employees further down the line, such as executives in charge of sales or production, may also want to participate in bonus pools based on corporate earnings, but the employer may also want to tie at least a portion of those executives' bonuses to factors over which those executives have more direct input, such as increases in sales or production efficiency. For public companies, bonuses have in some cases been tied to increases in share price; however, given the recent corporate accounting and executive compensation scandals, this type of bonus formula may not be attractive.
3. Change in Control Payments. A bonus or payment can be triggered upon a change in control of the employer (e.g., a sale or exchange of more than 50% of the equity ownership of employer). The purposes of the change in control payment can be to reward and/or protect the executive when new ownership of the employer enters the picture. Change in Control agreements are discussed in more detail in *Compensation and Exit Strategies* (Section VII below).

B. Stock Options

COMMENT: Prospective executive employees often ask for and expect an opportunity to participate in corporate growth through stock options. While the frequency of the use of stock options varies based on market conditions, stock options in any situation can be beneficial, both monetarily and psychologically, to both the employer and the employee. Stock options involve several corporate, tax and accounting issues, and both the employer and the employee should seek the advice of

competent legal and tax advisors in designing and negotiating stock option programs.

COMMENT: The granting of stock options can be subject to more scrutiny than in the past in light of the numerous corporate scandals in recent years. In brief, concerns have been raised about the financial incentives inherent in stock options and their effect on the behavior of certain corporate executives in public companies.

The following is a brief overview of some of the key issues related to stock options.

1. Pricing Issues. An executive employee would obviously prefer that the exercise price for the options be below the current market value as of the date of grant, so that the options are "in the money" right away (known as "discounted stock options"). The employer would prefer the options priced at or above current market value as of the date of grant in order to motivate the executive to work to increase the value of the corporation above its level at the time the options are issued. Unfortunately, Section 409A of the Internal Revenue Code creates some disincentives to issue discounted stock options. This is discussed further below in *Tax Issues* (Section V.C. below). The financial accounting treatment of stock options, particularly by public companies, is also an issue in pricing the options. If the employer is a public company, or has or intends to have its financial statements audited, then it should consult an accounting firm as to the financial accounting treatment of granting stock options.
2. Vesting Issues. The employer will want to use options as a retention and motivation tool, and thus will want to design a vesting schedule for the options that will meet those goals. Vesting can be designed to occur ratably in increments over a vesting schedule period, or to occur at one defined time (often called "cliff vesting") or to occur by a combination of ratably vesting and cliff vesting. For example, an employer may apply a 48 month vesting schedule to options granted to an executive, with the first 50% of the options vesting at the end of 24 months (the "cliff vesting" part) and with the remaining 50% of the options vesting in ratably monthly increments over months 25 to 48. The purpose of the "cliff vesting" is usually to incentivize the executive to stay with the employer for some minimum amount of time so as to make the employment engagement worthwhile to the employer. After the executive attains an agreed upon minimum term of service desired by the employer, it may become more reasonable for remaining unvested options to vest ratably in increments. The

employee will want to have the vesting periods coincide with the term of the employment contract and also receive accelerated vesting in the event of a change in control of the employer, in the event the employer goes public or if the employee is dismissed from employment without cause. If the executive cannot otherwise negotiate a full acceleration of vesting in the event that the executive is dismissed without cause, then the employee will want to consider negotiating a "clawback" right, which would allow the executive to receive the full benefit of his or her stock options in the event of an employer change of control, or if the employer goes public within a certain period of time after the employee is dismissed (usually six months to two years). A "clawback" provision guards against the executive being dismissed without cause prior to an event which would otherwise allow the executive to realize the value of his or her stock options. Vesting issues are often the source of the greatest disagreement when negotiating stock options.

3. Securities Law Issues. The issuance of stock options involves both federal and state securities laws. The issuance of options is the sale of a security and the employer must secure an exemption under the securities laws in order to avoid the costly process of registering the issuance. If the company goes public after the options are issued, the executive employee will want to have the opportunity to exercise the options and sell the stock in the public market as soon as possible. These issues are often overlooked by the employer and the executive, particularly in the case of small privately held companies, but they need to be addressed up-front in order to avoid both legal problems and misunderstandings down the road.

C. Tax Issues - An executive will be particularly sensitive to the tax consequences arising from the exercise of any options. The following is intended only as a brief overview and not as a comprehensive discussion of the tax issues related to stock options. The tax laws recognize two types of options: non-qualified and incentive.

1. Non-Qualified Stock Options. Upon exercise of a non-qualified stock option, the employee must recognize ordinary income equal to the "spread" at the time of exercise, which is the excess of the fair market value of the stock as of the date the options are exercised, less the exercise price. If the stock is sold after exercise, any appreciation in value subsequent to exercise will be treated as a capital gain, long-term if held for more than one year and short-term if held for one year or less. At the time of exercise of the option, the employer gets a tax deduction equal to the spread.

2. Section 409A. Under this tax law provision, if non-qualified stock options are "discounted stock options," that is, the exercise or "strike" price for the stock is less than the fair market value of the stock as of the date of the grant of the option, then a 20% penalty tax and accrual of interest on the tax can be imposed, depending on how the options are structured. Thus, in order to avoid the application of Section 409A, the options must be structured in one of the following ways: (a) the option must be granted at an exercise price no less than the fair market value of the stock as of the date of the grant, that is the options are not "discounted," or (b) if the exercise or "strike" price is less than the fair market value at the date of the grant (in other words, the options are "discounted"), then the options must either be exercisable only at a designated date or exercisable only in connection with termination of employment or a change of control of the employer. If the options are not to be "discounted," the Board of Directors of the employer cannot simply establish the fair market value of the stock arbitrarily—some level of due diligence as to the valuation is required. Either an independent appraisal or other significant valuation procedure must be undertaken. The bottom line is that discounted stock options have been rendered less attractive by Section 409A.
3. Incentive Stock Options (ISO's). Upon exercise of an incentive stock option, the employee recognizes no income under the regular income tax, but does have to include the spread in computing his or her "alternative minimum tax." Incentive stock options must be priced no lower than the fair market value of the stock as of the date the options are granted (thus, the ratios imposed by Section 409A referred to above do not apply). Several other technical requirements must be met in order for stock options to qualify as incentive stock options. If the stock is sold after exercise, the difference between the sale price and the original exercise price will be taxed as either capital gain or ordinary income depending on how long the stock is held after exercise. The employer does not get any tax deduction upon the exercise of incentive stock options.
4. Purchasing Restricted Stock. The employee will want to consider asking for the right to purchase employer stock directly, either at the time of hiring or, if granted options, before the options otherwise vest. This type of stock is often referred to as "restricted stock." The shares of stock purchased at the time of hiring or pursuant to the options but before they would otherwise vest, would themselves vest under a vesting schedule, and if the employee did not meet the vesting requirements, he or she would have to resell the stock back to the employer for the original

purchase price. This technique of issuing restricted stock is especially beneficial tax-wise to the employee in a start-up or financially distressed company where the stock value is low, and thus the outlay to purchase the stock will not be significant. At the time the employee buys the stock, he or she would file an election with the Internal Revenue Service (commonly known as a Section 83(b) election) and agree to take into income the "spread" at that time, rather than when the stock actually vests (when the spread could be much greater). The practical effect of this technique is to convert ordinary income into capital gains (currently taken at a lower rate) when the stock is ultimately sold after it vests. Section 409A will not apply to a direct purchase of stock at the time of hiring.

5. Tax Caveat. The tax issues related to stock options and restricted stock are complex and both employer and employee should always seek the advice of a competent tax advisor when adopting and negotiating stock options.

D. Phantom Stock and Stock Appreciation Rights

1. Generally. In lieu of stock options, some employers grant to their executive employees "phantom stock" or "stock appreciation rights" (SARs). Neither phantom stock nor SARs involve the actual issuance of corporate stock to the employee, and thus the employee will not possess the rights normally available to shareholders, such as the right to attend and vote at shareholder meetings, the right to examine corporate records or the right to institute shareholder derivative suits against the employer. Instead, phantom stock and SARs only grant the employee the right, upon exercise, to receive a cash payment from the employer based on the value of the actual stock held by the employer at certain times or upon the occurrence of certain events. In essence, phantom stock and SARs are cash bonus plans designed to track the value of the employer's stock. Both phantom stock and SARs are usually granted in the form of share equivalents.
2. Similarities and Differences between Phantom Stock and SARs. While the terms "phantom stock" and "SARs" are often used interchangeably, phantom stock traditionally refers to the economic equivalent of a full value share of stock in the employer: if a share of actual stock of the employer is worth \$10.00 at the time the employee exercised the right, the employee would be entitled to receive \$10.00 from the employer for each phantom stock share equivalent. On the other hand, a SARs traditionally refers to the economic equivalent of a stock option with an exercise price set at the date of grant (usually at the fair market

value of the underlying stock), so that, if at the time of the grant of a SARs share equivalent the actual stock of the employer is worth \$6.00 per share, and at the time the employee exercised the SARs the actual stock is worth \$10.00 per share, the employee would be entitled a payment of \$4.00 from the employer. Both phantom stock and SARs may be subject to vesting schedules and can be exercised either on dates certain or upon the occurrence of such events as sale of the employer, a change in control of the employer or the employer going public.

3. Tax Aspects. As with stock options, Section 409A of the Internal Revenue Code has substantially impacted SARs and phantom stock. Generally, Section 409A imposes similar requirements on SARs and phantom stock as are imposed on non-qualified stock options. Thus, in order to avoid the application of Section 409A, the rights must be equivalent to a traditional SARs—with an exercise price or "base price" equivalent to the fair market value of the underlying stock as of the date of grant, or the rights must be exercisable only at a specified date, upon termination of employment or change of control. Thus, Section 409A makes full value "phantom stock" less attractive to the executive employee.

COMMENT: From the employer's point of view, particularly in closely held businesses, SARs can be an attractive alternative to stock options because they avoid the grant of shareholder status to the employee and all the rights that ensue from shareholder status. However, our experience has shown that some employees are not as satisfied with SARs as they are with corporate stock options. An employee may feel that he or she is receiving something of inferior quality because they are not receiving "real stock" in the corporation. To some, there exists psychological satisfaction in holding and possessing a stock certificate representing actual stock, even if the stock is highly restricted.

E. Deferred Compensation

COMMENT: Executive employees may also ask for opportunities to defer a portion of their compensation to later years, both for financial and tax planning purposes. Deferred compensation arrangements for executives are usually outside of the employer's normal tax-qualified retirement plans (e.g., 401(k) or profit-sharing plans) and usually referred to as "non-qualified deferral compensation." These arrangements often give the executive employee the right to elect to defer a portion

of his or her current compensation to a later year. If non-qualified defined compensation is structured properly, the executive will not be taxed until he or she actually receives it; however, the employer's tax deduction is also deferred until the executive employee is taxed. As a security measure, the executive may also insist that the employer create a fund, or otherwise set aside the monies necessary to pay the deferred compensation in the future. Different devices may be utilized to set aside funds for the deferred payment, but they must be planned very carefully so as to not trigger taxation to the executive before the time the payments are to be actually received. Section 409A also applies to non-qualified deferred compensation. Several technical requirements that must be met in order to avoid the application of Section 409A. The most important of which is that the deferred compensation must be paid out over a fixed schedule, paid within the same tax year, or 2½ months after the year of separation from employment service, and the deferral election must be made before the year the compensation accrues. If the deferred compensation is structured so that the executive has access to it at the time of his or her own choosing then the negative consequences described above will apply.

COMMENT: Another form of deferred compensation involves the payment of death benefits to the families of executives, sometimes referred to as "Golden Coffins." In most cases Golden Coffins involve a combination of severance pay to the estate of a deceased executive and/or acceleration of unvested stock options upon the death of the executive. Proponents would argue these death benefits are appropriate to take care of the executive's family upon an unexpected death. Moreover, until recently some companies have offered these benefits in an effort to offer competitive compensation packages to recruit top talent. However, most recently activist shareholders of public companies have severely criticized these benefits and in some cases have challenged these benefits at annual shareholder meetings. The main criticism leveled at these benefits is that they are a wasteful payment of unearned compensation and run counter to the philosophy that executives should be primarily "paid

for performance.” There would be less pressure on these types of benefits at privately held companies.

VI. Executive Investment Opportunities and Pitfalls

- A. It is increasingly common for the employer to strongly encourage (or require) the executive to invest in the employer entity or its holding company, particularly when the entity is privately held and controlled by a private investment firm or venture capitalist. If the executive invests in the employer entity, then the executive has more than solely his or her employment contract at stake in working for the success of the business—the executive stands to lose his or her own investment as well. By the executive having "skin in the game," the executive has additional motivation to perform and increase the value of the business, and when the business is sold or goes public, the executive will likely benefit. Typically, the investment by the executive is usually in addition to any stock options granted to the executive. In some cases, an investment by the executive is a condition to employment; in other cases, it is not mandatory but highly recommended by the employer entity or the investment firm.

COMMENT: The amount the executive is allowed to or asked to invest varies, but in privately held firms the amount is usually well into six figures and, in some cases, into seven figures. The executive may be hesitant, or simply not have enough funds to invest all that is required. If the amount of the investment is substantial, the executive may seek to negotiate only a portion of the investment payable up front, with the rest payable by a promissory note. Ideally, the note should be non-recourse to the executive (that is, the executive should not have personal liability for the repayment of the note), and the note should be due only on or after the end of the time horizon the investment firm and the executive anticipate for the sale of the business or going public.

COMMENT: If the executive is investing his or her own money in the employer entity, the executive should take the investment with as few restrictions as possible. In particular, the executive should attempt to negotiate that if he or she leaves employment, the investment would not have to be sold back to the employer entity for less than its then current fair market value. A more aggressive position would be a "put right" held by the executive requiring the company to buy back the

executive's investment, often at a floor price equal to his or her original investment. As a compromise position, the executive may have to agree that if he or she leaves employment, the amount of the investment purchased by the unpaid portion of the note (if any portion of the note is still outstanding) would be subject to the employer's option to repurchase at its original purchase price, but the amount of the investment purchased with cash or through payments made on the note would be subject to repurchase back at its then current fair market value. With respect to any stock that is subject to repurchase at less than fair market value, the executive would have to consider making the Section 83(b) election with the IRS discussed above.

COMMENT: The executive should also attempt to negotiate the same rights with respect to his or her investment as the other shareholders (particularly any investment firm). These rights would include "registration rights" (the right to have the executive's investment registered if the employer entity goes public) and "tag-along rights" (the right to participate pro rata with the other shareholders in any sale of the equity). The executive may also want to attempt to negotiate an absolute right to sell the stock back to the employer at certain times for a fair market value price—irrespective of whether any other event then occurs. This right would allow the executive to cash out his or her investment without having to wait for a major liquidity event. Normally, this right is only negotiated for executives at the highest level.

VII. Compensation and Exit Strategies

In certain situations, an executive is brought in to turn a distressed company around and/or cause the company to grow through acquisitions or mergers with other companies or businesses. Before accepting employment in these situations, the executive will want to consider how he or she will participate in the economic benefits accruing to the company from its growth (through acquisitions or otherwise), and accruing to its owners if and when the company is sold and the executive "exits" the company. Some of the possible strategies for the executive in these situations are already discussed in Section V above regarding *Stock Options and Other Compensation Issues*, but the following is an overall summary of possible strategies. For purposes of this discussion, the employer entity will be referred to as the "company" and the equity interests in the company as "stock"; however, if a limited partnership or limited liability company is the form of

employer entity, the general principles discussed below will still apply, only with different equity types.

- A. Bonus Payments. The executive may be rewarded for growing the company, or upon the sale of the company, through the payment of pre-agreed cash bonuses. The executive can contract to receive bonuses based upon increases in corporate earnings or sales (see the discussion of *Formula Bonuses* in Section V.A.2 above). A "success bonus" can be crafted based upon a percentage of the ultimate sales price for the business or based upon the increase in value to or percentage return of the investment upon the sale of the business. A success bonus could also be crafted to pay the executive a fee for each merger or acquisition affected by the executive on behalf of the company and/or upon the ultimate sale of subsidiaries or divisions previously acquired. All bonus payments will be taxed to the executive at ordinary income rates and be subject to payroll tax withholding.
- B. Change in Control Agreements. As mentioned above in Section V regarding *Stock Options and Other Compensation Issues*, the executive may try to negotiate an agreement that entitles him or her to certain payments upon a "change in control" of the employer. The reasons to negotiate for such an agreement are varied. From the executive's point of view, he or she may have accepted employment in reliance upon his or her prior relationship or comfort level with the controlling shareholders. If the controlling shareholders transfer control to another group, the executive's relationship or comfort level may not be the same, and the executive may desire a way to exit with substantial compensation. From the controlling shareholders' point of view, they may want to turn-over their investment within a certain time frame, and look to find ways to motivate the executive to grow the business so as to promote the sale of the business as rapidly as possible.

Some of the issues that arise in connection with Change in Control agreements are:

1. Definition of Change in Control.

The definition of the "change in control" event that triggers the payments under the agreement is essential. Usually the "change in control" includes more than a 50% change in ownership, but can also include the sale or material reduction in the ownership position of a particular shareholder (with whom the executive has a particular relationship). The change in control can also include a material change in the board of directors, or the sale of a particular division or line of business of the employer. The executive needs to define the events that will materially change his or her position

with the employer and/or his or her relationship with the shareholders.

2. Compensation Payments.

The amount and method of computation of payments due to the executive upon a change in control can vary. In some cases, the payments are essentially equivalent to severance pay—equal to a number of months or years of base salary. In other cases, the payments are more in the nature of a "success payment" and based on a percentage of the sale price or a percentage of the return to the controlling shareholders. The executive will want the payments due upon the closing of the change in control event—however, the employer may want to make the payments due over an extended time period, usually six months to two years, particularly if the payments are conditioned upon future performance by the executive (discussed below).

3. Other Conditions.

Ideally, the executive will want the ability to leave employment with the company at or soon after the closing of the change in control event. However, the employer may negotiate certain "post-closing" conditions on the executive, tying a deferred payment schedule to satisfaction of those conditions. The employer may condition the payments upon the executive agreeing to stay on for a certain time period after the closing, usually six months to two years, as a transition period for new management. From the controlling shareholders' perspective, the company may be more saleable if the new owners have a commitment from existing management to stay on for some period of time to provide stability and ease the transition. The payments may also be conditioned upon the executive adhering to non-solicitation or non-compete covenants. All of these conditions can be subject to intense negotiations prior to the executive coming on board.

4. Tax Issues.

All cash payments under Change in Control agreements will be taxed at ordinary income tax rates and be subject to withholding and payroll taxes.

Payments under a Change in Control agreement may also be subject to the "parachute payment tax" under Section 280G of the Internal Revenue Code. This tax is equal to 20% of the "excess parachute payment" paid to certain executives upon a change in control of a corporation. This tax comes into play if the total

amount of payments due top executives (generally highest paid 1%), contingent upon a change in control, exceeds three times the average compensation paid to the executive over the five year period before the change in control. If this threshold is crossed, then the 20% is due on all amounts paid in excess of the five year average compensation amount (the "excess parachute payment"). The employer also loses the tax deduction for the excess parachute payment. Different ways for the executive to deal with the parachute payment tax include:

- a) Negotiate an "after tax" indemnity from the employer for the tax. Employers are often reluctant to do this since it may be relatively expensive.
- b) Limit the change in control payment to three times average compensation so as to avoid the problem.
- c) Limit the change of control payment to an amount that results in the lowest overall tax to the executive.

The parachute payment tax is not applicable to executives employed by partnerships, limited liability companies and subchapter S corporations.

An exception to the parachute payment tax for non-publicly traded corporations, arises when 75% of the shareholders approve the payments at the time of the change in control. The executive must not be entitled to the payments unless the shareholders first approve them. In other words, the executive must be willing to put the payments above the threshold at risk, subject to shareholder approval.

To the extent that the payments due as a result of a change in control are deferred compensation, then Section 409A of the Internal Revenue Code will also apply and must be considered in structuring the payments.

- C. Targeted Stock Options. Stock options can be designed to vest upon the achievement of earnings or acquisition goals or upon the investment firm attaining a certain return on its investment upon the sale of the business. In the case of stock options vesting only upon sale of the business, it is highly likely that the options will be exercised and the stock sold in a short period of time, resulting in the gain to the executive being taxed at ordinary income tax rates and will be subject to payroll tax withholding.
- D. Shareholder Rights. Whether the executive's stock in the company is acquired through stock options or direct investment, the executive should

be careful to see that he or she will be treated on par with the majority shareholders in the event the business is sold or it goes public. Typically, the executive should negotiate for "tag-along rights," which entitle the executive to elect to sell his or her stock at the same price and terms and in the same proportions as the majority owners if the majority shareholders receive an offer to purchase their stock from a third-party. If tag-along rights are negotiated, the majority shareholders will typically want "drag-along rights" as well, which allow the majority shareholders to force the executive to sell his or her stock at the same time and to the same extent the majority shareholders sell their stock. The purpose of tag-along rights and drag-along rights are to allow (or force) the executive and other participating minority shareholders to be treated on the same basis as the investment firm and the majority shareholders. The executive should also negotiate for "pre-emptive rights" with the employer entity, which grants the executive an option to participate in any private offerings of stock by the company in order to protect his or her equity position on a percentage basis. The executive will have to pay for the new shares at the same rate as the other purchasers, but the executive will preserve the right to maintain his or her ownership percentage. Finally, if it is at all possible that the company will go public in the future, the executive should negotiate for "registration rights" with respect to any stock owned by the executive. "Registration rights" allow the executive to have his or her stock registered in a public offering to the same extent as other shareholders.

- E. Exit Strategies. If the executive plans to "exit" the company upon the sale of the business or the business going public, the executive should attempt to negotiate one or more of the above compensation strategies before accepting employment.

- F. New Restrictions on Executive Pay. The Stimulus Bill recently signed into law by President Obama (the American Recovery and Reinvestment Act of 2009) sets new limitations on executive compensation with respect to entities receiving financial assistance from the Troubled Asset Recovery Program (TARP). In general, the new law does not restrict executive base pay, but does limit bonuses to certain executives for as long as the entity has any obligations arising from financial assistance provided under TARP. In general, bonuses can only be paid in restricted stock and cannot exceed 1/3 of the total amount of annual compensation. The number of executives at each entity affected by these limits is determined by a sliding scale based on the amount of TARP assistance received by the entity—the greater the amount of assistance received, the greater the number of executives affected. Prior to the enactment of this new law, the Treasury Department was working on its own set of regulatory restrictions on total executive compensation payable by certain entities receiving TARP assistance. As the federal bail-out and/or assistance programs develop, it is certainly possible that the limitations on

executive compensation will also be modified. Prior to accepting any employment with an entity receiving federal assistance, it is recommended that the executive, in consultation with his or her legal advisors, understand any limitations on compensation then applicable.

VIII. Negotiation Techniques

A. With legal counsel

1. May establish a more formal or adversarial tone, but it will be largely confined between the two attorneys rather than between the executive and employer.

COMMENT: There are two general dividing lines with regard to employment negotiations: with legal counsel and without. The use of legal counsel may set a more formal and sometimes adversarial tone in the discussions. However, if the executive has an attorney, this attorney will generally be having the discussions with the employer's counsel. Hopefully, both attorneys will be experienced with such negotiations which may allow for amicable negotiations. This will hopefully insulate the executive from conflicts. Thus, the executive may avoid a direct head-to-head battle with his or her future employer.

B. Without legal counsel

1. More friendly, but all "hidden" issues may not be covered – tax, security law concerns, etc.

COMMENT: If an executive does not use legal counsel, a more friendly atmosphere may exist. The executive may be treated as one of the team. The employer may give the executive a "standard" contract signed by all employees. In such a situation, care should be taken to carefully read the contract. If you do not understand any provision, contact your attorney. There may also be other "hidden issues" which are not apparent or addressed (e.g., securities law aspects, termination issues, tax issues, etc.). The executive can receive the advice of counsel regarding the agreement's terms, but not include the attorney in the direct negotiations.

C. Understanding the Role of the Executive Search Consultant

COMMENT: The executive search consultant is usually hired by the employer, and as such, owes primary loyalty to the employer. Be careful not to assume that the executive search consultant is your advocate. An executive can mistakenly assume that he or she can confide in executive search consultants. Instead, executives need to exercise caution on certain topics. Example: Candidate confides to executive search consultant "I really want a base salary of \$600,000.00 per year, but if pressed, I'd settle for \$500,000.00." In this instance, the candidate may have just given away valuable information that may be repeated to the employer and may cost the executive \$100,000.00 per year of base salary. On a five year term, the candidate may have lost a half a million dollars in base salary.

D. No Guts, No Glory vs. Poisoning the Well

COMMENT: Although the individual negotiations are friendlier and "team" oriented, an executive should remember the old axiom, "No guts, no glory." If you do not ask for certain benefits or provisions to be included in a contract, they probably will not be offered by the employer. Even if you are not certain they will be added, you should ask for them anyway if you have a reasonable basis to do so. You may be surprised and actually receive some or all of the requested revisions. Also, after the employer refuses to a number of valid items, it may be easier to get a few other items accepted. Any aggressive approach to negotiations should always be tempered by the fact that the executive will have an ongoing relationship with the employer after the negotiation is done. If negotiations bog down or start to become unduly adversarial, the executive must determine what terms are most important and continue to insist on them, but at the same time, keep the tone of the negotiations positive and avoid framing issues as "I win-you lose," which may poison the ongoing future relationship.

E. Avoid Starting Employment During Negotiations Without a Signed Agreement

COMMENT: As a general rule, an executive should not start working while contract negotiations are ongoing. At times, there

is an intention to formally document an arrangement after commencement of employment, but it never gets done. Then when things go bad, the executive can be summarily dismissed. It is very difficult for an executive to prove the existence of a binding oral arrangement when negotiations were on-going.

F. Document the Terms of Employment if at all Possible

COMMENT: On occasion, an employer will refuse to provide a written employment agreement or any other written documentation to an executive. In such case, the executive must weigh this lack of security against his or her present employment situation or other potential employment opportunities. However, if the executive wants to accept the offered position, steps can be taken to possibly establish the terms of the offered job. The executive can deliver a brief letter to the employer thanking them for the extension of the offer. The letter should succinctly recite the terms of the offer (position, salary, term, start date, benefits, etc.) with a closing statement that if there is any misunderstanding to the above terms, please contact the executive. If nothing else, the above action creates a negative confirmation of the job offer and its terms. This is not the best scenario, but it is better than only a handshake or an oral agreement.

G. Maintain Integrity During all Negotiations

COMMENT: Don't oversell yourself. Don't claim to be something you are not. Even a harmless misrepresentation can cause a prospective employer to question your integrity. An example would include telling an employer you were a star athlete in a given sport when, in fact, you never even played the sport or were an average participant.

H. Be Realistic in Accessing Your Negotiation Leverage

COMMENT: The executive needs to realistically assess his or her situation. Are you a "franchise" player (e.g., are you a sought after turn around expert or do you control a major account)? If so, you can certainly conduct your negotiations with considerable leverage and attempt to obtain a platinum agreement. If, on the other hand, you have been in transition for a considerable period of time

and generally need to be employed, a different negotiation posture may be required.

I. Be Pragmatic

COMMENT: If the executive has been in transition for some time and the employer will not offer any contractual protections, the executive may still need to give serious thought to accepting the position. A compromise position may be to take the job and continue the search for a better job with greater security.

IX. Certain Provisions to Address in an Executive Employment Agreement

A. Term of Employment

B. Position and Duties

1. Full time efforts and energies devoted to employment
2. Carve out permission for outside board positions or other desired activities and networking opportunities

C. Compensation

1. Base salary – specify minimum amount
2. Bonus – guaranteed payments vs discretionary vs formula payments
3. Benefits – e.g., insurance, 401(k), etc.
4. Perks - e.g., car, club memberships, etc.

D. Equity Participation, Including Stock Options, Grants, etc.

E. Termination

1. "For cause" by employer (typically no severance pay)
2. "For cause" or for "good reason" by executive (triggers severance pay)
3. "Without cause" by employer (triggers severance pay)

F. Change of Control Agreement – See discussion in Section VII for *Compensation and Exit Strategies*. This is a very important area that can be highly negotiated and can be the subject of a complex agreement.

G. Indemnification

1. Are there indemnity provisions and/or director's and officer's insurance provided by the employer? (Following the Enron and other similar fiascos, it is not desirable to accept executive responsibilities and potential liability without adequate indemnification protection.)

H. Severance Conditions – Do any apply?

1. Mitigation of damages (e.g., a reduction in the severance pay if the executive takes a new job)
2. Release agreement as precondition to receive severance

I. Choice of Law and Venue

J. Alternative Dispute Resolution – Pros and Cons

1. Mediation

COMMENT: Mediation is conducted with a trained mediator who attempts to settle a dispute between the parties.

2. Arbitration

COMMENT: Arbitration can be very expensive and time consuming. For example, filing fees with the American Arbitration Association (“AAA”) may be calculated as a percentage of the total damages sought in which can be much more expensive than the normal filing fees of a lawsuit.

K. Unique Provisions/Situations

1. Relocation of corporate headquarters
2. Turnaround companies
3. The family run company
4. Need to possibly review and/or consider impact of collateral agreements (for example: prior employment agreement provisions for severance pay, lender's forbearance agreement, existing or prior non-competition or non-solicitation agreements, etc.)
5. The venture capitalist as controlling shareholder

X. How to React if Fired or Asked to Resign

- A. Best reaction is to stay calm and not over-react
- B. Contract may require notice and right to review termination with decision makers (e.g. directors)
- C. Employer may have severance obligations
- D. Employer may offer valuable executive outplacement opportunities

COMMENT: If you are terminated, the best reaction is to display as little outward emotion as possible. If you fly off the handle, undesirable things may be said in the heat of the moment. Again, careful pre-planning will assist you in this time. The contract may require the employer to review the termination decision with you, giving you the opportunity to explain circumstances surrounding the potential problem. The employer may have generous severance obligations and may provide outplacement opportunities. In many instances, the employer would like nothing better than for you to find another job.

- E. Employer may offer unanticipated opportunities to consider. For example, a departing executive may be offered an opportunity to acquire certain assets of the Company.

XI. Restrictive Covenants

A. Non-competition and Non-solicitation Agreements

- 1. General description. Covenants not to compete are restraints on trade and are generally disfavored by court in Texas and elsewhere. However, covenants not to compete have become easier to enforce in Texas since a recent landmark decision by the Texas Supreme Court.
- 2. It is a common misconception that all non-competition agreements are always unenforceable in Texas. Well-crafted covenants not to compete and attention to providing proper consideration increase the likelihood of a covenant's enforceability.

COMMENT: Employers routinely attempt to prevent former executives from going into direct competition after leaving their employment. The employer's position may be that the executive was provided valuable

training and proprietary information (customer lists, trade secrets, etc.) Therefore, the employer will maintain that the executive should not be able to benefit from the receipt of this training and information to the detriment of the employer. The employer generally will seek to have the executive sign a non-competition agreement whereby the executive agrees not to compete in a defined geographic area for a defined length of time. As an alternative, the employer may identify certain clients that the executive is prohibited from going to work for or soliciting business from.

3. Texas Non-Compete Statute and Guidance from the Texas Supreme Court

COMMENT: In 1989, the Texas legislature passed the Covenant Not to Compete Act with an intent to clear up the confusion that previously existed in the area of non-competition agreements. Unfortunately, the court cases that followed somewhat clouded the issues. In an effort to provide some clarity, the Texas legislature amended the Covenant Not to Compete Act in June of 1993. While there were some inconsistencies between a strict reading of the statute and various court decisions, the Texas Supreme Court clarified much of the confusion in *Alex Sheshunoff Mgmt. Servs. v. Johnson*, 209 S.W.3d 644 (Tex. 2006). The Court made non-compete agreements significantly easier to enforce in Texas by shifting the focus away from contract law technicalities towards a more practical application. The *Sheshunoff* decision eliminated the difficult requirement of drafting an immediately enforceable covenant at the time of the execution of the agreement. For over a decade, many interpretations of the law required employers to almost simultaneously give employees confidential information in exchange for the employees' promise not to compete. The *Sheshunoff* decision clarified the uncertainties, explaining that the employer's part of the agreement does not need to be performed instantaneously with the signing of the agreement. Thus, the employer does not need to turn over confidential information at the time the agreement is executed. *Sheshunoff* held that a non-compete agreement is binding as long as the employer promises to provide, and does provide, confidential information during the course of the employment (or new confidential information in the case of an agreement

executed after initial employment). More recently, the Texas Supreme Court expanded the holding in *Sheshunoff* and relaxed the requirements on employers even further. In *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, No. 07-0490 (Tex. April 17, 2009), the Court held that an *implied* promise to provide confidential information, coupled with the employer later supplying the information to the employee during his employment, created an enforceable covenant not to compete. The Court reasoned that although the employer, an accounting firm, did not expressly promise to provide confidential information, the employee's promise not to disclose confidential information in the employment agreement was meaningless and could not be accomplished without the employer actually providing the information. Additionally, the Court held that the very nature of the accounting profession necessitated the employee's access to customer names, billing information and tax/financial information. Thus, by holding that an employer is not required to expressly promise but merely impliedly promise, and to provide confidential information in order to create a covenant not to compete, the *Mann* decision should give greater protection to employers, especially those rendering professional services and/or those working extensively with confidential customer information. Nevertheless, to ensure a stronger argument for enforceability, documented confidential information (or new confidential information) should be provided to the employee shortly after the agreement is signed.

COMMENT: The Texas Covenant Not to Compete Act provides that, in general terms, for a non-competition agreement to be enforceable, it: (i) must be ancillary to, or part of, an otherwise enforceable agreement at the time the agreement is made; (ii) must be reasonable as to time, geographical area, and scope of activity; and (iii) must not impose a greater restraint than is necessary to protect the goodwill or other business interests of the employer. While there are no clear rules about reasonableness, time periods longer than three (3) years (and in some circumstances, two (2) years or less) will likely be considered unreasonable time restraints. Employers should give greater care to narrowing the scope of the non-compete provisions. Courts may

reform unreasonable limitations in order to enforce such an agreement. However, if a court has to reform unreasonable limitations, employers are not entitled to damages for the time period before the reformation.

COMMENT: In addition, the courts generally require the consideration supporting the restrictive covenant to be appropriate, unique or confidential (e.g., typically disclosure of trade secrets, special training, etc.) Money, continued employment, a signing bonus, or a severance are not appropriate consideration to support a non-compete agreement. Employers should affirmatively, and in writing, promise to provide the confidential information to the employee. The non-compete clause should clearly state (1) that the employer shall provide confidential information, and (2) in turn, the employee promises to refrain from disclosing the information. Employers should keep records of the confidential information that was provided to the employee. This record will provide proof of the employer's consideration should a non-compete covenant ever need to be enforced.

COMMENT: From an employer's perspective, it is best to have the non-competition covenant signed by the executive upon commencement of employment and not thereafter. If the non-competition covenant is signed after employment begins, and after the executive has already received access to valuable trade secret information or other appropriate consideration, the agreement may not be enforceable unless the employer can prove that new and additional appropriate consideration was provided to support the restrictive covenant. New and valuable confidential information disclosed after the agreement was signed may support the covenant, but confidential information disclosed before the agreement was signed cannot be used.

COMMENT: Employers may want to consider adding language to the non-compete agreement that states: "**EMPLOYEE HEREBY WAIVES THE RIGHT TO CHALLENGE THE ENFORCEABILITY OF THE COVENANT NOT TO COMPETE.**"

4. In general terms, a well drafted covenant not to compete agreement that is part of an otherwise enforceable agreement may be enforceable as written in Texas, provided the covenant is

reasonable as to its scope (geography, time and area of restriction) and if the employer is protecting an important business interest. Recent court cases have limited the scope of restriction to non-solicitation of existing customers (rather than an absolute prohibition against working in the industry).

5. A non-solicitation agreement that prohibits an employee from soliciting certain customers and/or employees is more narrowly drafted in scope than an absolute non-competition agreement, and is generally more likely to be enforced by the courts in Texas. An agreement prohibiting an executive from soliciting employees of the employer is sometimes referred to as an anti-raiding covenant.
6. Around the country, states such as Florida, Louisiana and South Dakota permit covenants not to compete, but legislate the allowable terms of the agreements. For example, in South Dakota covenants not to compete cannot exceed two years and must be tailored to a specified county, first or second class municipality, or other specified area.
7. Some states have declared covenants not to compete void as a matter of public policy. Included in this list are Alabama, California, Hawaii, Montana, North Dakota and Oklahoma. The states mentioned that have enacted statutes prohibiting noncompete agreements provide exceptions to the rule for covenants dealing with: 1) the sale of the goodwill of a business, 2) disassociation of a partner from a partnership, or 3) upon dissolution of a partnership or limited liability company as long as the purchaser of the business or remaining partners carry on a like business.
8. In addition to providing general guidelines for the enforcement of non-competition covenants, the Texas statute included specific criteria for the enforcement of non-compete covenants against physicians. Other states, such as Colorado, Delaware and Massachusetts, have similar statutes expressly regulating physician non-compete agreements; either declaring restrictive covenants between physicians void or requiring them to comply with certain restrictions.
9. The District of Columbia has banned covenants not to compete altogether, providing: "every combination in the form of a trust or otherwise, or conspiracy in restraint of trade or commerce all or any part of which is within the District of Columbia is declared illegal."
10. Specific care should be taken to review any applicable non-compete law in the state of the executive's job performance and in

other states whose laws are stated to apply to the enforcement of the contract.

11. A covenant not to compete is easier to enforce when it is a part of the sale of a business. The courts generally recognize that significant sums are being paid for the goodwill of the company and equity requires the protection of that contractual term. In the sale of a business scenario, the Texas Covenant Not to Compete Act requires the promisor (i.e., the seller) bear the burden of providing that the covenant fails to meet the statutory criteria.
12. If an employer desires to protect its confidential and proprietary information given to the employee, a covenant not to compete may include a clause that prohibits the employee from using or disclosing such information. To be enforceable, the employer needs to limit the clause to the information the employee actually received and what information is actually confidential. The employer is also required to show what steps it has taken to keep the information confidential.

XII. Frequent Claims Asserted Against Executives by Former Employer (New Employers May Also Be Sued)

- A. Direct competition with the employer
- B. Soliciting of employer's customers
- C. Soliciting of employer's key employees
- D. Misappropriation of employer's confidential information or trade secrets
- E. Usurption of corporate opportunity
- F. Breach of fiduciary duty
- G. Harassment/fraternization
- H. Breach of employment contracts
- I. Civil conspiracy (conspiring with other employees or former employees to harm employer)

XIII. Executives Who Are Shareholders In Closely Held Corporations May Be Forced Out By Majority

- A. Enforcement of buy-sell agreement

- B. Accounting to determine value
- C. Disgorgement of profits
- D. Claims of shareholder oppression against minority shareholders
- E. Appointment of receiver to manage business
- F. Slander/libel as to executive's performance

XIV. Lawsuits

A. Injunction Actions

1. If the executive engages in any of the normally prohibited acts described above, an employer may seek injunctive relief.
 - a. Temporary injunctions to prevent certain conduct by a former employee may be instituted while the case is pending, yet years could pass before a final disposition is reached.
 - b. Defense of claims for injunctive relief is very expensive—it requires a mini-trial, usually compressed into a two to three week period.

B. If a lawsuit is filed by the employee, the employee should have "clean hands"

COMMENT: If a dispute does arise, and a lawsuit is necessary, it is best if the party filing the suit can come to the court with "clean hands." As an example, if an employee is seeking a severance payment from the employer, the court will be less sympathetic if it is shown that the employee has been soliciting employer's customers in violation of a non-competition agreement.

COMMENT: Careful pre-planning can also help resolve problems if they should arise. The employment contract may have mandatory alternative dispute resolution (ADR) provisions such as mediation and/or arbitration.

- C. Even if not named as a Defendant in the lawsuit by the former employer against the employee, the new employer may still become involved in the discovery process. The former employer may subpoena records and request access to the employee's computer at the new employer to prove improper competition.

XV. Job Preservation

- A. Preventative measures should be considered in your efforts to preserve your executive position. Be realistic when assessing your strengths and weaknesses. Are you difficult to work with? Are you too demanding? Are you lacking in people skills? If you can't be realistic about yourself, hire someone who can be. Example: consider a properly qualified executive coaching advisor to help you. As a caveat however, be aware that no privilege exists regarding your discussions. In other words, if the executive coach is required to give a deposition, the executive coach will have an obligation to answer all questions relating to discussions with you during the training session.
- B. Seek professional advice when appropriate. For example, a CEO can sometimes insulate himself or herself from blame by seeking and relying upon legal and/or accounting advice before making a controversial decision. Many executives fail to do this.
- C. Stay networked. It is very important to maintain networking activities whether employed or not. If an executive is in transition, the benefits of networking are obvious. But equally as important are the benefits of staying connected to the right people, because most executives are potentially a day away from termination because of unforeseen events, change in management, bankruptcy of the employer, etc.

XVI. Other Issues Applicable to Executives

- A. Asset Protection. More than ever before, C-level executives are exposed to potential personal liability for their actions – whether pursuant to federal laws such as Sarbanes-Oxley, pursuant to federal or state regulatory actions, or pursuant to suits by shareholders or creditors of the employer. All C-level executives should consider reasonable and prudent steps to protect their hard earned assets from potential claims. There are numerous ways to protect assets from creditors and important and sophisticated legal issues are usually involved. The intent of this outline is not to present a detailed discussion of asset protection and surrounding legal issues. Any executive interested in asset protection should first seek advice from an attorney before undertaking any actions in that area. The key to any asset protection program is to start it before potential liabilities

arise; in other words, plan early and plan ahead. Once a claimant makes a demand against the executive, and certainly once a lawsuit is filed against the executive, the ability of the executive to engage in any asset protection that will withstand legal attack will be greatly diminished. Thus, it is highly recommended that if an executive is interested in asset protection planning that he or she consult an attorney or other qualified professional before problems arise.

- B. Marital Property Issues. Divorce rates in the United States are very high and executives, as a group, are probably no different than the national average.
1. If an executive is contemplating marriage after obtaining a lucrative employment agreement and/or equity rights in his or her employer, the executive should consider a premarital agreement which protects his or her income and/or equity rights.
 2. If the executive is facing the prospect of divorce, then the executive should, as soon as possible, consult an attorney familiar with marital property laws. In many cases, there may be proactive steps the executive can take to better position his or her assets (including equity rights in the employer) once the divorce case is commenced.
- C. Public Company Investigations. If you are an executive of a public company, be especially on guard when investigations are commenced by your audit committee on behalf of the Board, the SEC or other governmental agencies. You should not talk to outside auditors or outside counsel to the company or anyone in the company, even the general counsel, if your actions are under investigation until you have first sought legal advice. You may even have criminal exposures that you have not considered.

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