EXECUTIVE EMPLOYMENT ISSUES AND CONCERNS

by
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November 2015

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- Sports Law Litigation

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- Represented videogame developer in school shooting cases in Columbine, CO, and Paducah, KY.
- Represented professional athlete against brokerage company for misappropriation of funds.

- Represented investment advisor in arbitration proceeding in defense of claims over suitability of investments.
- Represented professional athlete against insurance carrier and insurance agent for insurance code violations, fraud and negligence in failure to procure sports disability insurance.
- Represented sports broadcaster against claims of defamation and tortious interference with contractual relations.
- Represented company in defending claims by minority shareholder for breach of shareholder buy-sell agreement and shareholder oppression.

Representative Cases:

- James v. Meow Media, Inc., 90 F. Supp.2d 798 (D. Ky. 2000) (U.S. District Court Western District of Kentucky 2000)
- James v. Meow Media, Inc., 300 F.3d 683 (6th Cir. 2002) (U.S. Court of Appeals 6th Circuit 2002) Sanders v. Acclaim
- Entertainment, Inc., 188 F. Supp.2d 1264 (D. Colo. 2002) (U.S. District Court District of Colorado 2002)

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- U.S. District Court Northern District of Texas
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EXECUTIVE EMPLOYMENT ISSUE AND CONCERNS

I. INTRODUCTION

A. This outline will address, on a cursory level, certain executive employment issues and concerns with an emphasis on litigation, non-compete agreements and contractual matters.[1]

B. Executive employment related litigation issues are common and can include (among many others) the employer's right to terminate an executive for cause, severance pay, the enforcement of a non-compete agreement, claims of breach of fiduciary duty, misappropriation of trade secrets and usurpation of a corporate opportunity. This outline will briefly address these potential litigation issues and others.

C. From the executive's perspective, the days of remaining with your employer until you receive a gold watch and retire are long gone. Executive terminations occur more frequently than in the past. Bankruptcies, corporate sales and restructuring can unexpectedly cause a termination. Private equity groups investing significant capital in a business often times will insist upon the right to bring in their own executive team to run the business and safeguard their investment. Unfortunately, a top notch executive can lose his or her position with a company without warning, and in many cases, without justification. For example, an excellent CFO may be terminated for no other reason than the incoming CEO required a replacement with a history of loyalty to the CEO. From an employer's perspective, executives must be accountable for the performance of a company. Achieving the desired performance benchmarks or even the very survival of a distressed company may depend upon the skills and adaptability of the executive in a challenging economic environment. Excuses by an executive for failure to perform will generally not be tolerated by investors and the employer.

D. Executive level employees need to exercise care when beginning employment with a new employer. Contractual protections in today's marketplace are important and necessary. A well drafted agreement (which can be in the form of a letter agreement) is advisable for the protection of the executive and employer. When negotiating employment agreements and even offer letters, executives need to clearly define their performance and compensation expectations. Prudent executives should

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[1] This outline originated as part of a presentation to C-level executives. This outline has been updated and revised over the years based primarily on the author's experiences in representing executives and employers. The author acknowledges his appreciation for the contributions and input received from several members of his firm Hiersche, Hayward, Drakeley & Urbach PC regarding the topics in this outline.

also anticipate and prepare for eventual separation from their employer. Likewise, an employer needs to protect its legitimate interests when hiring an executive and needs to carefully outline its expectations, performance goals, restrictive covenants and provide for adequate remedies if the executive fails to perform.

E. An executive and the prospective employer need to realistically assess the relative strengths and/or weaknesses of their respective 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. Seeking to be treated like a franchise player when the executive lacks such credentials will be viewed as foolish by the employer. Simply put, an executive and employer must be able to realistically assess their negotiating leverage.

F. Many employers want the C-level executive (particularly at the CEO, President and CFO 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 evaluate not only employment related issues but also investment and tax issues if a substantial sum of money will be invested in the company.

G. An executive needs to 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 three-year period.

H. An executive who reports to the Board of Directors needs to exercise care when providing written reports 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.

I. Importantly, recently enacted tax laws and economic recovery laws will affect the compensation structuring of executive employment agreements (see further discussion herein).[2]

II. GENERAL EMPLOYMENT LAW PRINCIPLES

A. Texas and many other states are “at-will” employment states. The employment relationship between the employer and the employee can generally be terminated at any time, for any reason, or for no reason by

[2] When negotiating executive employment agreements (especially those involving meaningful equity and deferred compensation) the assistance of competent tax counsel is generally advisable and necessary.

either employer or employee. In a handful of states, the law may impose a covenant of good faith and fair dealing on employers that is essentially read into the employment relationship. Thus, termination under these circumstances can be subject to something along the lines of a "just cause" standard. Texas and most other states reject this exception, recognizing that judicial oversight into the motives behind employment decisions is an overwhelming and inefficient undertaking. 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.

B. Means in which an employment contract or certain protections 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.

C. 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 concise; stating 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.)

D. An employment contract may, in certain limited cases, 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, then suspension, with termination following), the employer may be required to follow each discipline step prior to termination. 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 if the employment at-will doctrine is materially altered. However, most well drafted employee handbooks clearly state there is no indirect contractual relationship and the employee at-will relationship is reaffirmed.

E. An employment contract can be 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. Length of employment can be obtained through an agreed upon employment term (e.g., 3 years). If the executive employee is terminated, the contract may require the employer to continue paying salary and other benefits throughout the term and 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.

An Employment Contract Can Modify the "At-Will" Relationship

F. The employment contract can also modify the at-will relationship by limiting the employer's termination rights to predefined "cause" events. In other words, the employer cannot terminate the executive without a contractually defined "for cause" event. 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 performance 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 rare 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.

The Executive Should Seek "Good Reason" Termination Rights.

G. The executive should seek to describe circumstances giving the executive the right to terminate for "good reason." These circumstances may include a material diminution 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 employer should request that the executive be required to give the employer immediate notice (e.g., within 30 days of the "good reason" event) to cure the "good reason" termination event. Upon a termination by the executive for "good reason," the executive will typically be seeking the payment of a pre-defined severance amount as set forth in the contract. The employer asserts to protect its interests by seeking preconditions to paying the executive a predefined severance, as set forth in the contract.

Cautionary Note: A "Good Reason" Termination Needs to be Done With Great Care.

H. If a "good reason" termination is not done properly, the executive will likely be deemed to have voluntarily resigned and may forfeit rights to severance and potentially other valuable contract rights.

I. The employment contract should define the specific benefits to be provided executive employees during their employment. This may include benefits such as vacation, medical coverage, automobile allowance and club memberships, but may also include payment of professional dues for a CFO, membership dues for certain executive networking groups, incentive bonuses, stock options and 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.)

J. The employer can identify employment terms for valued executives to remain with the executive in the event there is a parting of the ways. Although many employers prefer not to have employment contracts for most employees, a written contract is an opportunity for the employer to succinctly state its relationship with the executive. The executive's duties can be specifically defined. The "at-will" relationship can be re-affirmed in a contract. 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.

K. Restrictive covenants are very important to protect the interests of the employer. 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 confidential information or trade secrets, the employer, at the time of initiating employment, will likely want non-competition, non-solicitation, anti-raiding and confidentiality provisions. Such clauses are an attempt to legally prevent the executive from using the employer to obtain industry knowledge and contacts, and then using them in direct competition against the employer during the term of the employment and thereafter. Such restrictive covenants 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, vendors and suppliers.

A Prudent Employer Should Require Incoming Executives to Make Important Representations Before Commencing Work

L. An employer should obtain a representation that an incoming executive is a "free agent" (i.e., that the executive is free from any contractual restrictions that would prohibit the executive's ability to work for the employer). Moreover, it is prudent from the employer's perspective to have the incoming executive represent he or she is not bringing to the employer any stolen goods (i.e., any confidential or trade secrets information from a prior employer). For example, new employees that bring and download stolen trade secrets on the new employer's computer network will expose the new employer to several potential claims, including tortious interference with contractual relations and violation of the Texas Uniform Trade Secrets Act ("TUTSA") enacted on September 1, 2013.

Failure to obtain these employee representations can cost the new employer substantial dollars in preventable legal fees. Simply put, the new employer needs to make sure the incoming employee is not radioactive in any way before hiring such person. Obtaining important representations before the employee commences work can be very beneficial to the new employer.

M. An executive needs to be very careful about not inadvertently giving away to the employer a preexisting relationship that the executive cultivated prior to accepting a position with a new employer. In other words, the executive needs to carefully protect his or her rolodex. For example, assume that an executive is hired by a new company because of his or her preexisting relationship with an extremely large or prestigious customer(s). If the executive is required to sign a non-solicitation agreement, the executive may not be able to retain this critical relationship, and the executive may be prevented from taking these customer(s) to a future new employer (a potential competitor of the former employer) in the event of termination. A carve out provision pertaining to those relationships should be drafted and inserted in the executive's non-solicitation agreement.

N. 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.

O. The employer may require the execution of a release agreement in the future as a pre-condition to the executive's receipt of severance. Executives should exercise care before agreeing to sign a release favoring the employer. The employer will typically require such a release before paying severance benefits. Further, if signing a release is a contractual precondition to receiving severance pay, it is advisable to review and negotiate the actual form of the release at the time the employment agreement is signed. The executive may want to draft 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 may precondition the severance payments upon compliance with certain agreements set forth in the separation agreement (*e.g.,* compliance with a non-compete agreement).

P. Some employers may want the executive to have "skin in the game" and invest in the company. (See discussion below in Section X.) Additional documentation will likely need to be prepared to protect the executive's equity investment.

III. CERTAIN PROVISIONS TO ADDRESS IN AN EXECUTIVE EMPLOYMENT AGREEMENT

A. Term of Employment – Specify if it is a stated number of years or until terminated.

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. – These are becoming less common. The emphasis (especially with larger companies) is on performance based compensation.

D. Equity Participation, Including Equity Options

E. Termination

1. "For cause" by employer (typically no severance pay).

2. "For cause" by employer or for "good reason" by executive (triggers severance pay).

3. "Without cause" by employer (triggers severance pay).

4. Disability / Death – typically provides no severance pay.

F. Change of Control Agreement – See discussion in Section XI 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 Issues

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.)

2. If the executive anticipates a possible lawsuit over a non-compete agreement, or generally about any information he may know or retain from a prior employer, it is prudent to have frank discussions through counsel with the new employer. It is also very desirable to obtain an agreement from the new employer to stand behind the executive to fund the defense of any lawsuit that may follow against the executive.

3. NOTE: From the employer's perspective, it is always best to anticipate a potential lawsuit based on an executive transferring information or material from a prior employer. Although there are several steps that may be taken to mitigate this risk, an employer should require an affirmative statement, in writing from an executive that he or she has not misappropriated any information or material from a prior employer and that he or she will not utilize any information, material, or trade secrets from a prior employer in his or her duties with the new employer.

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 (*e.g.*, will the dispute be governed by Texas law and will it be brought in a specified county in Texas?)

J. Alternative Dispute Resolution – Pros and Cons

1. Mediation. Mediation is typically a non-binding settlement procedure conducted with a trained mediator who attempts to resolve a dispute between the parties. If not successful, the parties can proceed to litigate their dispute.

Cautionary Note: Arbitration has many Risks and Pitfalls.

2. Arbitration. Arbitration can be 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. If three arbitrators are required and the arbitration proceeding will last for several weeks, the arbitrators' fees will be very substantial. There are other potential problems with arbitration proceedings, including very limited or non-existent subpoena powers for out-of-state witnesses, generally no appeal rights and traditional rules of evidence and procedure do not apply.

K. Unique Provision/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.
6. Foreign owned companies and culture issues.

IV. LAWSUITS AND EMPLOYMENT RELATED CLAIMS & ISSUES

A. There are many types of lawsuits that occur between executives and employers. It is well beyond the scope of this outline to address all the various types of legal proceedings that may occur. A realistic assessment of financial resources is essential before an executive or employer commits to a path of litigation.

B. Frequent claims asserted in lawsuits involving executives and employers may include the following:

1. Direct or indirect competition with the employer in violation of a non-compete agreement.

2. Soliciting of employer's customers in violation of a non-solicitation agreement.

3. Soliciting of employer's key employees in violation of an anti-raiding agreement.

4. Misappropriation of employer's confidential information or theft of trade secrets, including claims under the TUTSA.

5. Usurpation of corporate opportunity.

6. Breach of fiduciary duty.

7. Harassment/fraternization.

8. Breach of investment and employment contracts.

9. Civil conspiracy (conspiring with other employees or former employees to harm employer).

10. Tortious interference with existing contract (common claim asserted against executive's new employer).

11. Declaratory judgment as to the rights and obligations of the executive under a non-compete or non-solicitation covenant.

12. Fraud, including claims for common law fraud and under the Computer Fraud and Abuse Act.

C. What is a "Trade Secret" under the TUTSA?

1. Since September 1, 2013, Texas has defined in TUTSA what is meant by the term "trade secret."

2. Under TUTSA, a "trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, process, financial data or list of actual or potential customers or suppliers, that:

(A) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and

(B) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

3. The existence or not of a trade secret is a fact specific analysis and is often times heavily litigated. For example, a plaintiff must demonstrate that the alleged trade secret has been the subject of efforts to protect it that are "reasonable under the circumstances."

4. Under TUTSA, a court may award the recovery of attorneys' fees to either side in the litigation depending upon who prevails.

5. If an employee has not signed a non-compete, but has misappropriated trade secrets, attorneys will likely argue that TUTSA permits a court to prevent by injunctive relief a threatened misappropriation of trade secrets. A court may be asked under such circumstances to prevent an employee from working for a competitor (even if a non-compete agreement does not exist) if it is necessary to do so to prevent disclosure of a trade secret.

6. The laws of trade secret litigation are well beyond the scope of this outline. Suffice it to say, if a trade secret is believed to be misappropriated, claims under TUTSA will most assuredly be raised in any ensuing litigation. Remedies under TUTSA include both money damages and injunctive relief.

D. Injunction Actions

1. If the executive engages in any of the normally prohibited acts described above (particularly the violation of a restrictive covenant or the misappropriation or theft of trade secrets), an employer may file suit and seek immediate injunctive relief in the form of a temporary restraining order ("TRO").

   a. Defense of lawsuits seeking injunctive relief is very expensive. It typically involves accelerated discovery and a mini-trial in the form of a temporary injunction hearing, usually compressed into a two to three week period following the filing of the lawsuit.

   b. Obtaining a TRO, or any substantial form of injunctive relief, can be a game changer and afford the party that obtains such relief substantial leverage in the litigation.

E. Recovery of attorneys' fees and costs

1. If the executive is sued for breaching an employment agreement or violating the TUTSA, the employer will most certainly also seek a recovery of attorneys' fees and costs which can be substantial in a high stakes lawsuit.

2. If there is a declaratory judgment claim in the lawsuit, the court will have discretion to award attorneys' fees to the prevailing party.

3. If significant attorneys' fees will be incurred by either side, and recovery of those fees is a claim in the lawsuit, an expert witness on attorneys' fees may need to be engaged.

F. If a lawsuit is filed by the executive against the employer, the executive should have "clean hands." If a dispute does arise, and a lawsuit is necessary, it is best if the party filing the suit can come to court with "clean hands." As an example, if an executive is seeking a severance payment from the employer, the court will be less sympathetic if it is shown that the executive has been soliciting the employer's customers in violation of a non-competition agreement, or if the executive misappropriated the employer's confidential information. Careful pre-planning may also help avoid or resolve problems before litigation if they should arise. Legal counsel should be consulted as soon as a potential lawsuit is anticipated.

G. Likewise, the employer filing the suit against the executive should come to court with "clean hands." For example, an employer in a suit seeking damages against an executive for breach of fiduciary duty should expect the executive to highlight for the judge and jury all instances where the employer had unclean hands.

H. Even if not named as a defendant in the lawsuit by the former employer against the executive, the new employer may still become involved in the discovery process. The former employer may subpoena records and request access to the executive's computer at the new employer to prove such claims as theft of trade secrets or violation of a non-compete agreement.

I. Executives who are also owners of a closely held business may be forced out by a majority of the owners. In such circumstances, the governing documents (*e.g.* buy-sell agreements) will need to be carefully examined. Common types of claims that may arise in this situation include:

1. Declaratory judgment as to rights and obligations of parties to a buy-sell agreement.

2. Accounting action to determine value of executive's ownership.

3. Possible claim of shareholder oppression against majority shareholders.

4. Appointment of receiver to manage business if it is being improperly run.

5. Defamation action regarding executive's reputation.

J. Executives should be very careful about creating harmful discoverable evidence. For example, e-mails and text messages detailing an employee's plans to compete against the employer are discoverable and may be devastating in a lawsuit to claims asserted against an executive for an alleged breach of a non-compete agreement. Executives should also avoid using the company's email account for confidential communications with the executive's attorneys, accountants or family members. Similarly, downloading a company's confidential information without permission onto an external hard drive (i.e., a thumb drive) can cause a departing executive substantial problems once the company discovers the conduct. This is also true if an employee "forwards" emails to either himself or others from the company's email account or by "uploading" documents from company servers to the employee's private email or to a cloud based storage program. This conduct will be viewed as theft, and the risk of litigation is substantially increased. Forensic experts are regularly engaged by attorneys to discover this type of conduct.

K. An employer should immediately obtain from a departing executive all property belonging to the employer, including laptops, iPads, cell phones, files, hard drives, thumb drives, etc. If the executive was provided access to especially sensitive and confidential information, consider hiring a forensic computer firm to make a ghost drive of all electronic devices used by the executive. It is generally not a good idea to have your IT Department do this task. It is prudent to consult your attorney to hire a forensic computer expert to make sure this critical preservation of evidence is done correctly and to provide expert testimony in court if needed. Steps taken immediately can avoid costly exposures at a later date.

L. Financial resources can have a significant impact in litigation. The early stages of a lawsuit seeking injunctive relief can be very expensive. Typically, employers that institute lawsuits have the necessary funds to go to battle. The executive needs to also have a sufficient war chest to keep the playing field level. Defending a lawsuit can economically decimate an individual. The executive's new employer *may* step in to financially assist the executive if the executive is viewed as a valuable asset.

M. Many employment agreements routinely seek to waive the executive's right to a jury trial. This is a very valuable right for an executive to give up. A jury can sometimes be an executive's best and only hope to level the playing field and afford a fair trial. A good jury has wisdom to

perceive the equities and dispense justice. We generally advise retaining the right to a jury trial if at all possible.

N. More executive agreements are waiving trials by a court or jury and requiring arbitrations. The common perception is that arbitrations are quicker and less expensive than a trial by the court or jury, but that is not always true. As stated earlier in this outline, arbitrations have many potential problems and risks (e.g., they can be very expensive, there are no appeal rights, the rules of evidence do not strictly apply so hearsay and irrelevant documents are often times considered by the arbitration panel in arriving at a decision).

O. Employers ultimately may need to make the decision to sue a departing executive for violating a restrictive covenant or for some other reason. Sometimes the employer has no real option. For example, if the executive is causing material harm to the employer's business operations. Other times, the decision is more difficult and a shot across the bow with a threatening letter may do the trick. Sometimes litigation will be absolutely essential and other times it may be avoided.

V. CONTRACT NEGOTIATION TECHNIQUES

A. With legal counsel

1. There are several ways of conducting negotiations with regard to employment contracts. Legal counsel can serve as lead negotiator or the executive can negotiate on his or her own behalf. Another approach is a blended approach where both the executive and counsel negotiate or utilize the attorney as the coach to the executive. The use of legal counsel as lead negotiator 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. Sometimes a blended approach of using legal counsel for difficult legal issues and having the executive negotiate business related issues works well.

B. Without legal counsel

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

2. If an executive does not use legal counsel, a friendlier 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.*, tax issues, termination issues, etc.) The executive can receive the advice of counsel regarding the agreement's terms, but not include the attorney in the direct negotiations.

3. At times, it may be advantageous to keep the executive as front line negotiator to interact with the employer with the attorney behind the scenes as coach. This is always a judgment call depending on the facts and circumstances of the issues being negotiated.

C. Understanding the Role of the Executive Recruiter

1. The executive recruiter is usually hired by the employer, and as such, owes loyalty to the employer. While the recruiter may be of great assistance to making the deal happen, the recruiter that is hired by the employer is not the executive's advocate. An executive can mistakenly assume that he or she can totally confide in executive search consultants. Seasoned executives realize the need to exercise reasonable 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 prospective new 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 with that comment.

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

1. 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 consider asking for them anyway if you have a reasonable basis to do so. In other words, it is often prudent to adopt a reasonably aggressive approach. You may be surprised and actually receive some or all of the requested revisions. Also, after the employer refuses a number of valid items, it may be easier to

get a few other items accepted. All negotiations should 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. Scorched earth tactics will generally be counterproductive.

E. Avoid Starting Employment During Negotiations Without a Signed Agreement

1. 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

1. 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

1. 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 Assessing Your Negotiation Leverage

1. The executive needs to realistically access his or her situation. Are you a "franchise" player (*e.g.*, are you a sought after turnaround expert or do you control a major account)? If so, you can certainly conduct your negotiations with considerable leverage and attempt to obtain a very favorable 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

1. 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.

VI. NON-COMPETE AGREEMENTS

A. Practical consideration

1. The first important question to ask if you are the employer is why do you need one? If you do not have your work force under non-compete agreements, you will need to be careful before going to your employees and requiring everyone to sign a non-compete. That request may cause several valued employees to resign.

2. Do not overreach. Many non-compete agreements are so broad in scope that they would not be enforced as written. For example, a provision prohibiting an employee from working "in any capacity" anywhere in the world for a competitive company will almost certainly not be enforced as written.

B. Non-compete Agreements - General Comments

1. Probably one of the most litigated issues in the Texas courts involves the enforceability of non-compete and non-solicitation agreements. These agreements are very important to executives and should be very carefully analyzed and negotiated before an executive agrees to their terms.

2. Covenants not to compete have historically been disfavored by courts in Texas and elsewhere. However, covenants not to compete have, in the past few years, become easier to enforce in Texas provided the covenant follows the requirements of the Texas Non-Compete Act and the guidelines set forth in recent cases by the Texas Supreme Court.

3. The law surrounding non-compete agreements is constantly changing and careful attention to court cases is essential in understanding the latest legal nuances and requirements for enforcement. It is a misconception that some executives and employers hold that non-competition agreements are unenforceable in Texas. This is not true. Well drafted covenants not to compete that provide proper legal consideration and are reasonable in scope and duration are enforceable in Texas.

4. Employers routinely attempt to prevent former executives from going into 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.) Or, the employer may argue that the granting of stock or stock options creates a protectable right in the goodwill of the company. As a result, the employer will maintain that the executive should not be able to benefit from the receipt of this training, information and/or company equity 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 certain defined industry in a defined geographic area for a defined length of time. As an alternative or in conjunction with such a non-compete agreement, the employer may seek a non-solicitation agreement and thereby prohibit the executive from going to work for or soliciting business from the employer's present or prospective customers.

C. Texas Non-Compete Act

1. In 1989, the Texas legislature passed the Texas Non-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 Texas Non-Compete Act in June 1993.

2. The Texas Non-Compete Act provides, 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.

3. In addition to providing general guidelines for the enforcement of non-competition covenants, the Texas statute includes specific criteria for the enforcement of non-compete covenants against physicians.

4. Important Note: The Texas Non-Compete Act does not define what it is to be a "covenant not to compete." Moreover, the Texas Supreme Court has not yet directly answered the question of what it means to be a covenant not to compete. In fact, in 2014, the Texas Supreme Court in *Exxon Mobil Corp. v Drennen*, 452 S.W.3d 319 (Tex. 2014) stated "it is not necessary here to answer the question of what it means to be a covenant not to compete…"

   In the *Drennen* case, the Texas Supreme Court held that a provision which appeared in a non-contributory executive incentive plan and which prohibited an executive from working for a competing company was, in fact, not a non-compete agreement. (See discussion of *Drennen* below.)

D. Important Texas Supreme Court Decisions

1. While there were some inconsistencies between a strict reading of the Texas statute and various court decisions, the Texas Supreme Court clarified much of the confusion in *Alex Sheshunoff Mgmt. Servs., L.P. 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).

2. In 2009, 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,* 289 S.W.3d 844 (Tex. 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, a direct promise to provide the information should be made by the employer, and documented confidential information (or new confidential information) should be provided to the employee shortly after the agreement is signed.

3. On June 24, 2011, the Texas Supreme Court decided *Marsh USA Inc. v. Cook*, 354 S.W.3d 764 (Tex. 2011). In this case, the Texas Supreme Court held that the consideration of stock options for a non-compete agreement was reasonably related to the company's interest in protecting its goodwill and therefore sufficient to support a non-compete covenant. The decision is a significant departure from the long-held view that money or financial considerations could not constitute a sufficient consideration for a non-compete covenant. The Texas Supreme Court appears now to be refocusing its enforcement analysis away from technical requirements and going back to the basics of a reasonableness

analysis under the circumstances. In *Marsh*, the former employee was considered a "key" employee and signed the non-compete restriction in exchange for stock options. The Court determined that the awarding of the stock options linked the interest of a key employee to that of the company. These interests are different than other employees, because owner-employees benefit from the growth and development of the company. Owners' interests are furthered by fostering the goodwill between the employer and its clients. Thus, the stock options are reasonably related to the protection of business goodwill and make the covenant not to compete ancillary to an otherwise enforceable agreement. The protection of goodwill, along with the exchange of confidential information, will be important factors in analyzing future non-compete agreements in terms of enforceability.

4. An agreement prohibiting an executive from soliciting employees of the employer is sometimes referred to as an anti-raiding covenant. In *Marsh*, for the first time, the Texas Supreme Court made a statement that a non-solicitation of employee restriction will fall under analysis of the Texas Non-Compete Act. "Covenants that place limits on former employees' professional mobility or restrict their solicitation of the former employers' customers and employees are restraints on trade and are governed by the Act." In the past, courts have generally treated employee anti-raiding clauses under a traditional contractual enforcement analysis. However, this language in *Marsh* raises questions on whether anti-raiding clauses must now meet the strict standards of traditional non-compete restrictions.

5. In 2014, the Texas Supreme Court decided the case of *Exxon Mobil Corp. v. Drennen*, cited earlier in this outline. This case addressed forfeiture of pay provisions commonly found in equity based incentive compensation plans. The Court upheld a non-compete forfeiture provision in an executive compensation plan that applied New York law. The Court stated that there is a distinction between a covenant not to compete and a forfeiture provision in a non-contributory profit-sharing plan because such plans do not restrict the employee's right to future employment; rather these plans force the employee to choose between competing with the former employer without restraint from the former employer and accepting benefits of the retirement plan to which the employee contributed nothing. The Court clearly held that Exon Mobil's Incentive Programs do not involve covenants not to compete. In this case, the Court noted that New York law permitted the enforcement of so-called detrimental activity provisions in executive bonus-compensation incentive programs,

such that an employer may lawfully terminate the outstanding awards upon a breach of the incentive programs and the executive's voluntary resignation from the employer to take a position with employer's competitor. The rationale for this forfeiture was the employee, by enrolling in the incentive program, agreed he would forfeit any outstanding awards should he engage in activity determined to be detrimental to the interest of the employer or should he accept employment with a competitor of employer. In the *Drennen* case, the Texas Supreme Court stated "whatever it may mean to be a covenant not to compete under Texas law, forfeiture clauses in non-contributory profit sharing plans, like the detrimental activity provisions in Exxon Mobil's Incentive Program, clearly are not covenants not to compete."

6. There are open questions following the *Drennen* decision. For example, the Court stated that whether or not detrimental activity provisions are unreasonable restraints of trade under Texas law such that they are unenforceable is a separate question and one which the Court reserved for another day.

E. Recent Examples of Post-*Marsh* Cases Either Upholding or Not Upholding Covenants Not to Compete.

Courts Will More Likely Enforce a Covenant Not to Compete When it is Related to the Sale of a Business

1. In June 2012, the Fort Worth Court of Appeals held that a covenant not to compete for a ten-year period was enforceable where it was related to the sale of a business. In *Heritage Operating, L.P. v. Rhine Bros., LLC*, 02-10-00474-CV, 2012 WL 2344864 (Tex. App.—Fort Worth June 21, 2012, no pet.), the Court recognized that, while the statute does not distinguish the two, a covenant not to compete signed by an owner selling a business is quite different from a covenant not to compete signed by an employee. The Court held that a ten-year restriction period was reasonable when it was associated with the sale of a business and suggested that such a covenant not to compete might even be reasonable where it was for an indefinite period of time.

2. In October 2012, the Texarkana Court of Appeals clarified the *Marsh* standard for when stock options will support a covenant not to compete. In *Lazer Spot, Inc. v. Hiring Partners, Inc.*, 387 S.W.3d 40 (Tex. App.—Texarkana 2012, pet. denied), the Court struck down a covenant not to compete where the employees in question were not "key employees" and held that the covenants

with the employees in question were not necessary to protect and foster the goodwill of the business.

3. The courts will require evidence of the status of an employee as a "key employee" and will not merely defer to the employer's classification. The employer should also be prepared to show that the consideration for the covenant not to compete is actually reasonably related to the protection of the business goodwill.

4. In February of 2013, the Tyler Court of Appeals held that a covenant not to compete that prevented a cardiologist from practicing in a small community with a large population needing cardiologists was unenforceable because it violated public policy. In *Nacogdoches Heart Clinic, P.A. v. Pokala*, 12-11-00133-CV, 2013 WL 451810 (Tex. App.—Tyler Feb. 6, 2013, pet. denied), the Court determined that a covenant not to compete violated public policy by weighing the employer's interest in enforcing the covenant against the public policy interest against such enforcement. The Court specifically stated that it is appropriate to consider whether enforcement of the covenant not to compete would harm the public interest by resulting in inadequate healthcare or continuity of care and depriving the public of access to the physician of its choice.

5. Special care should be used when drafting covenants not to compete involving practicing physicians where enforcement of the covenant could prevent the public from receiving healthcare. To maximize the potential to have these types of covenants enforced, they should be drafted as narrowly as possible and should not restrict the physician from practicing medicine in general, but should be specifically limited to the relevant specialty.

6. Although the Texas Supreme Court in *Marsh* and the cases preceding it have clearly signaled that covenants not to compete are looked at favorably in Texas, the lower courts may still look for any reason they can find to invalidate them. Thus, it is critical that special attention is paid when drafting such covenants to ensure that they comply with the Texas Non-Compete Act and the standards identified by the Texas Supreme Court.

F. Drafting Restrictive Covenants (assuming Texas law applies)

1. Use plain English so the restrictive covenants are easy to read and understandable. Avoid unnecessary legalese.

2. When drafting non-compete agreements, the drafter must appreciate that Texas courts generally require the consideration

supporting the restrictive covenant to be appropriate, unique or confidential (*e.g.,* typically disclosure of trade secrets, special training, preservation of goodwill, etc.) Money, continued employment, a signing bonus or a severance are <u>not</u> typically appropriate consideration to support a non-compete agreement. For example, employers should affirmatively, and in writing, promise to provide 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 that the employer's consideration was actually given should a non-compete covenant ever need to be enforced.

3. Below are some drafting suggestions from the perspective of protecting the employer:

   a. Identify the executive as a "key employee" (and be prepared with evidence to support it). Other terms used in the non-compete in *Marsh* were "valuable" and "select" employee.

   b. Identify that the executive will be working to develop and enhance goodwill for the company, and that the company will own the goodwill.

   c. Identify that the executive will be given access to important client relationships.

   d. State that there is a link and nexus between the confidential information being given to the executive and the goodwill attendant to the executive's activities with the harm to result to the company if such confidential information is disclosed or if the goodwill is used for someone other than the company.

   e. The plan that was at issue in *Marsh* was described as a plan that served to enhance the relationships between Marsh and its customers by helping the company retain highly motivated executives with an interest in the long-term success of the company, which, in turn enhances the goodwill of Marsh. The covenant not to compete … prevents employees from using that goodwill (i.e., the relationship between Marsh, the employee and the customer) to attract the customer to a competitor.

f. Have the executive confirm the reasonableness of the restrictions in the agreement and that they are related to the protection of the legitimate and valuable business interests of the company worthy of protection.

g. In anti-raiding clauses, review to see if they would be viewed as "reasonable." Include in the anti-raiding clauses the same analysis, and for same stated special consideration given, for non-compete. Also, in anti-raiding, make sure to include both – you will not solicit, and you will not hire clauses.

h. 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 be more challenging to enforce unless the employer can prove that new and additional appropriate consideration was provided to support the restrictive covenant. New and valuable confidential information disclosed <u>after</u> the agreement was signed may support the covenant, but confidential information disclosed <u>before</u> the agreement was signed cannot be used.

i. Employers may want to consider adding language to the non-compete agreement that states in sum or substance: "**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. Some 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 industry preclusion non-competition

agreement, and is generally more likely to be enforced by Texas courts.

G. Outside Texas

1. 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.

2. Some states have declared covenants not to compete void as a matter of public policy and unenforceable. California and North Dakota are very restrictive with respect to non-compete agreements. The states mentioned that have enacted statutes prohibiting non-compete 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.

3. Other states, such as Colorado, Delaware and Massachusetts, have statutes similar to Texas expressly regulating physician non-compete agreements; either declaring restrictive covenants between physicians void or requiring them to comply with certain restrictions.

4. 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."

5. 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.

6. 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 Non-Compete Act requires that the promisor (i.e., the seller) bear the burden of proving that the covenant fails to meet the statutory criteria.

7. 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.

8. Regardless of any contractual provisions, an employee has a duty not to use or disclose an employer's confidential and proprietary information in a manner adverse to the employer, even after the termination of employment.

H. Reformation of Over Broad Non-Compete Agreements

1. Under Section 15.50(a) of the Texas Non-Compete Act, a covenant not to compete is enforceable only "to the extent it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promise." A Texas court must reform the agreement so as to make it reasonable and enforceable if the restrictive covenant is ancillary to or part of an otherwise enforceable agreement but is over broad in its terms.

2. If a non-compete is over broad, reformation will become an issue in a non-compete case and the consequences will be significant. Generally, a court awards injunctive relief, damages or both when a covenant not to compete is breached. However, under Section 15.51(c) of the Texas Non-Compete Act, if the covenant at issue is over broad, a court "may not award the promisee damages for a breach of the covenant before its reformation and the relief granted to the promisee shall be limited to injunctive relief."

3. Also significant to note is that until the over broad restrictive covenant is reformed by the court, it cannot form the basis of an action for tortious interference against the person (typically the new employer) that is engaging the services of the individual bound by the covenant.

4. As an additional note of caution, if an employer seeks to enforce in Texas an over broad restrictive covenant to a greater extent than necessary to protect the legitimate business interests of the employer, a court may award costs and reasonable attorneys' fees incurred by the employee in defending the action.

VII. TERMINATION OF EMPLOYMENT

A. The ending of an executive employment relationship is a common occurrence and should be anticipated by both executive and employer. There are numerous factors which may lead to the decision to terminate employment: economic downturn, sale of the business, 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 between the executive and the employer. This factor should not 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 better fits the chemistry or cultural needs of the employer.

In the instances where a company is being sold, merged or some other significant corporate transaction is occurring the executive 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 6-12 months. Prudent planning is vital in these instances.

In addition, due to increased personal exposure of directors, there is a potential that an executive will be sacrificed, if necessary, in favor of the directors.

B. Executive Perspective

1. It is of paramount importance for an executive to preserve his or her good name and reputation in the event of a 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."

4. You can (and should) prepare in advance for a potential termination. 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 scapegoat to insulate another officer or 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.

5. An executive employment contract typically provides for severance benefits upon termination, including compensation and often times 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.

6. Often, a major part of an executive's compensation may be in equity options or other equity instruments. Care should be taken to preserve an executive's rights upon a termination of employment. Termination "without cause" may be structured in a way to accelerate non-vested options. Many times, compensation packages heavily weighted with options may be illusory if these are non-vested options that are revoked upon termination.

7. If an employment agreement or contract contains a non-competition agreement, 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.

8. Tax Issues. Effective January 1, 2005, Congress passed 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 equity options and stock appreciation rights is discussed further in *Tax Issues* (Section VIII.F. below). In structuring any deferred compensation or separation pay, the IRS Regulations and IRS Rulings must be consulted.

C. Employer Perspective

1. If "at-will," no cause is necessary, no notice is required and no severance is required in the event an executive is terminated. However, there may be instances where the employer is best served by providing a severance package, even if not legally required to do so. For example, an employee whose future cooperation is critical to the needs of the company may obtain severance benefits coupled with future cooperation obligations.

2. Carefully document "cause," if any, both before (if applicable or possible) and upon termination. Discriminatory reason should not, under any circumstances, 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).

3. Whatever the reason leading to the termination, the decision should be made in a lawful and appropriate manner. Generally, 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.

4. Discrimination should not play any part in the decision to terminate any employee. As an example, if the decision to fire was made 90% because of lack of performance and a mere 10% was because the employer did not want to make accommodations to

enable the employee's continued work after a disability, this action is potentially unlawful and could result in a lawsuit. Unlawful discrimination is when a decision is based (even slightly) on sex, race, age, religious belief, veteran's status or disability (or other characteristics protected by applicable federal or state laws).

5. 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 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.

VIII. SEPARATION AND RELEASE AGREEMENTS

A. Often, the executive and the employer will want to enter into a separation and release 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 care in drafting.

1. Before agreeing to a separation and release agreement, the executive needs to 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. The executive may not be contractually entitled to any severance, but the employer may still be willing to provide certain post termination benefits in exchange for a release agreement.

C. 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.

D. One sided 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 release. If the employer agrees to provide this, the employer may want to carve out an exception for bad acts like fraud or embezzlement.

E. 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. Sizeable employers are usually resistant to broad non-disparagement clauses because it is difficult to control an entire workforce. However, in certain instances, the executive may receive important protection if the non-disparagement clause will bind the employer and only its top management.

F. As stated above, in order to avoid acceleration of tax on severance pay and a 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.

IX. EQUITY 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 employer has the total discretion to pay the executive employee an amount of bonus at the end of the year (or other period) 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 XI below).

B. Equity Options.

1. Prospective executive employees often ask for and expect an opportunity to participate in entity growth through stock options or similar options to acquire equity in a non-corporate entity. While the frequency of the use of equity options varies based on market conditions, equity options in any situation can be beneficial, both monetarily and psychologically, to both the employer and the employee. Equity 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 equity option programs.

2. The granting of equity 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 equity options and their effect on the behavior of certain corporate executives in public companies.

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

Pricing Issues. An executive employee would obviously prefer that the exercise price for the equity options be below the current market value of the underlying equity as of the date of grant, so that the options are "in the money" right away (known as "discounted 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 options. This is discussed further below in *Tax Issues* (Section IX.C. below). The financial accounting treatment of equity options, particularly for companies that have their financial statements audited, is also an issue in pricing the options. If the employer has or intends to have its financial statements audited, then it should consult an accounting firm as to the financial accounting treatment of granting equity options.

Vesting Issues. The employer will want to use equity 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, to occur at one defined time (often called "cliff vesting") or to occur by a combination of ratable 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 ratable 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 equity 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 equity options. Vesting issues are often the source of the greatest disagreement when negotiating equity options.

Securities Law Issues. The issuance of equity options involves both federal and state securities laws. The issuance of equity 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 equity 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. With respect to corporations and corporate stock, the tax laws recognize two types of options: non-qualified stock options and incentive stock options.

1. Non-Qualified Stock Options ("NQSOs"). Upon exercise of NQSOs, 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 NQSO, the employer gets a tax deduction equal to the spread. The federal income tax rates for individuals were amended after the 2012 election to provide a 15.8% difference between the maximum rate on ordinary income (39.6%) and the maximum rate on long-term capital gains (23.8%).

2. Section 409A. Under this tax law provision, if NQSOs are "discounted 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 acceleration of ordinary income tax as the options vest, 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, NQSOs must be structured in one of the following ways: (a) NQSOs 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 NQSOs 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 NQSOs must either be exercised only at a designated date or exercisable only in connection with termination of employment or a change of control of the employer. If the NQSOs 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 NQSOs have been rendered less attractive by Section 409A.

3. Incentive Stock Options ("ISOs"). Upon exercise of ISOs, 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." ISOs must be priced no lower than the fair market value of the stock as of the date the options are granted (thus, the extra requirements imposed by Section 409A referred to above do not apply). Several other technical requirements must be met in order for ISOs to qualify for this treatment. 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 an ISO.

4. Options to Acquire Equity in Non-Corporate Equity. For privately held businesses, the legal entity of choice is increasingly the

limited liability company ("LLC") or limited partnership ("LP"). These entities are taxed as partnerships for federal income tax purposes and options to acquire equity in those entities are subject to some but not all of the same tax rules and requirements as corporate stock options. In general, options to acquire equity in LLC's and LP's are subject to tax rules similar to NQSOs. ISOs cannot be issued by LLC's, LP's or any other non-corporate entities. However, due to the substantial tax benefits available by granting "profits interests" in LLC's and LP's, the privilege of granting equity options in such non-corporate entities has decreased. A further discussion concerning the granting of "profits interests" is provided below.

5. Purchasing Restricted Equity. The employee will want to consider asking for the right to purchase, or be granted for no consideration, employer equity directly, either at the time of hiring or, if granted options, before the options otherwise vest. This type of equity stock is often referred to as "restricted stock" if a corporation is involved, or "restricted equity" if a non-corporate entity such as an LLC or LP is involved. The shares of stock or equity purchased or granted 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 or equity is especially beneficial tax-wise to the employee in a start-up or financially distressed company where the value is low, and thus, the outlay to purchase the equity will not be significant or not be required at all. At the time the employee buys or is otherwise issued the stock or equity, 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 or equity 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 or equity.

6. Profits Interests. Increasingly, a way to provide equity to executives of non-corporate entities (LLC's and LP's) is to grant "profits interests." This technique is not available for corporations and corporate stock. In essence, a grant of a profits interest in an LLC or LP is equity interest shares in future operating cash flow and future growth in entity that value, but has no interest in the value of the entity as of the date of grant. As a simple example, if

an executive is granted a 1% “profit interest” in an LLC and the LLC has total enterprise value of $5,000,000 as of the date of the grant, then the executive would have no economic interest in the existing $5,000,000 value, but could share in 1% of operating cash flow and 1% of growth in entity value upon the sale of the above $5,000,000. If structured properly, the grant of a profits interest to an executive will (i) result in no cash outlay by the executive; (ii) result in no taxable income to the executive as of the date of grant; and (iii) gain will be taxed at long-term capital gains rates (23.8% maximum) upon sale of the entity instead of ordinary income rates (39.6% maximum) normally associated with equity options. Legally, a profits interest is a real equity interest in the granting entity and the executive will be treated as a partner for federal income tax purposes each year. A vesting schedule similar to equity options or restricted equity can be imposed. In order to make the profits interest work properly, the entity must do its due diligence to determine the full enterprise value of the entity so as to make sure the profits interest does not entitle the executive to any of the current value of the entity as of the date of the grant. Due to the substantial tax advantages of profits interest, the trend among privately held business entities doing business as LLC’s or LP’s is to grant equity to executives in the form of profits interests instead of through equity options.

7. Tax Caveat. The tax issues related to equity options, restricted equity and profits interests 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 corporate 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. Phantom stock and SARs

are not used as often in LLC's and LP's context due to the significant tax advantages of granting profits interests (discussed above). However, if phantom stock or SARs are used in the LLC and LP context, similar considerations apply.

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 "SAR" 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 to 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 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 can make full value "phantom stock" much less attractive to the executive employee.

From the employer's point of view, particularly in closely held corporation, 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.

An Executive Needs to Get All Promises Made About Future Equity Terms in Writing.

E. Often times when a company is seeking to hire an executive, there is a great urgency to get the executive on board. Promises, whether verbal or in writing, are made to the executive that equity will be granted after the executive starts employment. Even if there is a writing of some sort given to the executive regarding equity before employment is started, the writing is often vague, lacks sufficient detail and is generally unenforceable. We strongly recommend that the executive negotiate and obtain a binding, written agreement prior to starting employment, setting out in sufficient detail the terms of equity, including price, number of units or shares, vesting terms (if any), buy-back rights and shareholder rights. Failure to obtain this agreement prior to starting employment runs the risk for the executive that the company will not follow through on its "promises" to grant the equity as the executive understood and may lead the executive and the company to a path of costly litigation.

F. Deferred Compensation

1. 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 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.

2. 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 (often funded by life insurance) 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 is likely less pressure on these types of benefits at privately held companies.

X. EXECUTIVE INVESTMENT OPPORTUNITIES AND PITFALLS

A. It is common for the employer to 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 equity options or restricted equity granted to the executive and is purchased at the then current fair market value of the equity, often the same price recently paid by the majority shareholders and is fully vested upon purchase. In some cases, an investment by the executive is a condition to employment; in other cases, it is not mandatory but encouraged by the employer entity or the investment firm.

1. The amount the executive is allowed to or asked to invest varies, but in privately held firms the amount is usually well into six or 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.

2. 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 equity that is subject to forfeiture or repurchase by the employer at less than fair market value, the executive would have to consider making the Section 83(b) election with the IRS (discussed above).

3. 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.

XI. 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 IX above regarding *Equity 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 an LP or LLC 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 IX.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 IX regarding *Equity 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, and the recent trend in public companies is not to provide an after tax indemnity.
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, LLC's and closely held corporations that could quality as subchapter S corporations (whether or not the election is actually made).

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. As a practical matter, this is often the route taken to avoid the parachute tax in privately held companies.

Change of control agreements must also comply with Section 409A in order to avoid the negative consequences described herein – acceleration of ordinary income tax, 2% penalty tax and interest on the tax. The change in control event must fit within the definition of change in control set out in IRS regulations.

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 equity interest 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.

XII. JOB PRESERVATION AND HOW TO REACT IF TERMINATED

A. Prudent proactive 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, an executive can sometimes insulate himself or herself from blame by seeking and relying upon professional 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 while employed, since most executives are potentially a day away from termination because of unforeseen events (*e.g.,* change in management, bankruptcy of the employer, etc.).

D. If an executive is fired or asked to resign, stay calm and do not overreact. Contact legal counsel if the termination is believed to be wrongful. If the executive had a well drafted employment contract, it may afford severance payments and allow for notice and rights to review certain termination decisions.

E. The Employer may offer valuable executive outplacement opportunities. 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 if a termination should occur. 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.

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

XIII. OTHER MISCELLANEOUS ISSUES APPLICABLE TO EXECUTIVES

A. Asset Protection. More than ever before, executives are exposed to potential personal liability for their actions – whether pursuant to federal laws such as Sarbanes-Oxley, federal or state regulatory actions or suits by shareholders or creditors of the employer. Executives (including officers, directors and C-level executives) should consider reasonable and prudent steps to protect their hard earned assets from potential claims. There are legitimate 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 seek advice from a qualified attorney before undertaking any actions in that area. The key to any asset protection program is to start it before potential problems or 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 may want to consider a premarital agreement which protects his or her income and/or equity rights. The enforceability of such an agreement is of clear importance and it is therefore important to seek competent counsel from a family law attorney well versed in this area prior to entering into such an agreement.

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 careful when investigations are commenced by your audit committee on behalf of the Board, the SEC or other governmental agencies that may involve your actions or conduct. You should not talk to outside auditors or outside counsel of 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. Be aware that counsel for the company likely does not (and could not) represent the executive individually, so an employee, and especially executive, should seek independent legal counsel before speaking to anyone inside or outside of the company about any investigation.

D. The General Counsel. The executive should understand the legal duties and responsibilities of the employer's General Counsel. Friendships aside, the General Counsel owes fiduciary duties to the employer and not to the executive. The General Counsel will not place the interests of the executive above the interests of the employer. The General Counsel does not represent the executive. The executive should not confide in the General Counsel as to personal issues since there will be no attorney-client privilege.

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