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Negotiating and Drafting Employment Agreements

Leading Lawyers on Constructing Effective Employment Contracts

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Constructing Solid Employment Agreements

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Introduction

Employment agreements define the specific rights and obligations of the employer and the employee. Not all organizations use employment agreements, and those that do have them do not use them for all employees. Broadly speaking, employment agreements are entered into with high-level employees at smaller companies and highly compensated employees at larger companies. Most public companies use employment agreements for C-suite executives.

The use of employment agreements can help employers achieve many goals, including to:

1. limit disputes concerning compensation;
2. attain stability and uniformity with respect to employment terms amongst the executive ranks;
3. ensure private resolution of employee claims; and
4. protect legitimate company assets from competitors.

If properly written, these agreements can be an invaluable tool in attracting and retaining executives. They also benefit employees seeking written commitments to the terms of their employment.

There are numerous considerations at play when deciding how to structure an employment agreement. As a litigator, I analyze contractual provisions from the perspective of how will they will be construed when the employment relationship sours, and, of course, with an eye toward avoiding ambiguity and other issues that may lead to litigation in the future. When representing companies, an attorney should always caution the client against providing compensation or benefits that might draw negative attention from shareholder groups or regulators, or that future employees could use to bargain for greater rights than the company would ordinarily offer. The goal should be to set compensation and benefits at the point that will attract, retain, and incentivize the executive to perform to the best of his or her ability on behalf of the company, without crossing the line into excessive compensation.[1] When representing the executive, the attorney should be particularly wary of post-employment restrictive covenants and payment terms upon termination. In all cases, however, the practitioner should strive to prepare a contract that contains clear and legally enforceable terms that the client can rely on to administer its employment practices in compliance with the law and with the knowledge that it will withstand scrutiny should a dispute arise.

The Latest Trends in Employment Agreements

Trends in employment agreements are difficult to identify until they become the norm. This is clear when reviewing contracts in the financial services industry and with regard to C-suite executives at public companies, where they have been prevalent for many years. In that industry, there has been a steady migration toward hybrid compensation plans, including cash and non-cash bonuses, stock and stock options, and non-vested cash bonus awards, all of which are now more frequently subject to claw-back provisions in the event of termination for "cause" or where financial statements must be restated, causing the performance goals not to be satisfied. These provisions offer significant protection for companies and shareholders against employees who commit wrongful acts, but who have already received the bulk of their compensation, and are a key tool in the challenge of aligning compensation with company performance—an elusive goal that has certainly been in the spotlight for many years now, not always for the most flattering reasons.

There has also been a trend favoring use of non-solicit and non-hire provisions over non-compete provisions to prohibit solicitation of customers and employees and a move toward refinement of restrictive covenants in general (*i.e.*, non-compete, non-solicit, and non-hire provisions) to prevent former employees from unfairly competing with their now former employer; soliciting company clients and vendors made known to the employees through their services to their employer; and hiring

[1] I refer to "excessive compensation" as a general matter, not as it may apply in specific instances, such as in the case of a not-for-profit corporation or under Dodd-Frank § 956, in which case penalties may attach. 12 U.S.C.A. § 5641 (West 2012) (becoming effective July 22, 2010).

other company employees to either start a competing venture or join the former employees at an existing company.

Companies invest enormous resources to attract and develop their employees, obtain and maintain client relationships, and select and collaborate with trusted vendors. Competitors and departing employees should not be permitted to harm relationships with impunity, but these provisions must be carefully crafted to comply with the laws of the state in which the services are provided and in which the employee resides because of the strong public policy in favor of competition and freedom to contract. Sometimes, even careful planning can be insufficient, as California courts will not respect any restraint on competition, even if the former employee submitted to a non-compete provision while he or she lived and worked in another state and then moved to California to join a competitor. Fortunately for employers, no other state so utterly prohibits non-compete agreements.

In addition, companies in all industries increasingly include arbitration provisions to foster private resolution of employee disputes. Arbitration is not a panacea that will remedy all costs attendant to dispute resolution, but it can significantly reduce the actual out-of-pocket costs arising out of employee claims, keep sensitive internal information out of the public eye, eliminate the possibility for punitive damages and generally avoid other instances of jury over-reaching, and eliminate years of appellate or class action litigation. Many companies insist on including arbitration provisions in all employment agreements.

These trends affect not just new employees, but also existing employees. More than once in the past year, I have been consulted to prepare and review replacement employment agreements being offered to C-suite employees company-wide. Although this is fairly unusual, it is a good practice to promote consistency within an organization and avoid the negative effects that result from piecemeal changes. In such circumstances, there is likely to be little individual negotiation, but the terms are likely to be favorable to the executives as a whole.

One issue that has recently been on the minds of most employment attorneys and compensation consultants is the effect of the Dodd-Frank

Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank was, in part, a response to the perceived widespread excessive pay practices at the nation's largest financial services institutions. It includes many subparts, one of which prohibits "excessive compensation" at financial services companies with more than $1 billion in assets. Dodd-Frank § 956 requires disclosure of the structure of all incentive compensation arrangements to determine whether they: provide an executive officer, director, employee or principal shareholder with "excessive compensation," fees, or benefits, or could lead to material financial loss. Thus, the company must now analyze its plans and agreements in advance to comply with this law. Although this should help keep compensation in line with shareholder interests, many experts in the field have argued that, as with "say on pay" requirements included in Dodd-Frank, this has not had the intended effect. Often, this is a result of inappropriate identification of peer companies or setting target goals that are too easily attainable. Employment lawyers counseling corporate clients are well advised to work closely with compensation consultants to avoid such practices.

Lastly, many companies that have traditionally used employment agreements or offer letters for all employees continue to find them useful in complying with ever-increasing wage and hour regulations. For example, as of April 2011, New York's Wage Theft Prevention Act requires all covered entities to provide notices to all new employees stating:

1. the employee's rate or rates of pay, and the basis thereof;
2. how the employee will be paid (hourly, shift, daily, weekly, etc.);
3. whether the employer intends to claim any allowance as part of the minimum wage (tip, meal, housing);
4. when the pay date will occur; and
5. the name, address, and telephone number of the employer, including any "doing business as" name that the employer may use.

The Act also requires all employers to provide annual notices to all employees on or before February 1. Employers that use employment agreements or offer letters for all employees may include this information in those documents and provide supplemental annual notices to comply with this new law.

The "Most Important" Terms of the Agreement

The relative importance of terms in employment agreements varies from employer to employer and employee to employee. For some employers, protecting company information and other employees from competitors is most important. For others, flexibility in compensation is paramount. The key to effective representation is to understand your client's business needs and draft contractual provisions that will best achieve those goals. It is important to note in this regard that, although there is no need to "recreate the wheel," one should avoid the use of prior agreements that do not adequately address the current client's needs. Moreover, I caution corporate clients against using a standard contract for all new hires without discussing with counsel the particular issues that might require adjustments to be made due to differences in duties and positions. With that said, the following terms are almost always going to be considered important:

At-Will or Term

Most states adhere to the employment "at-will" doctrine, which means that either the employee or the employer may terminate the employment relationship for no reason or any reason, provided that the reason is not prohibited by law. Sometimes, however, it is advantageous to provide for a specific period of time during which the employment agreement will be in effect. This is most often used for very senior executives. Term agreements provide certainty to the employer and the employee that the relationship will continue for at least the specified period, subject to financial consequences should the employer or employee terminate the agreement prior to its expiration. I note that this arrangement is not to be confused with a guaranty of compensation for a particular period of time, which may be used in both term and at-will agreements.

Compensation

It is the extremely rare instance when compensation is not an important term, indeed, the most important term, of the employment agreement. This is often the term in which recruits are most interested and is always central to the parties' agreement. Usually, the parties agree upon the terms of compensation first, and then ask the attorneys to prepare the agreement.

The attorney is primarily responsible for ensuring that the business terms are clearly stated in the agreement so that each party receives the benefit of the bargain it struck. Securing the business deal is the employment attorney's ultimate responsibility.

It is important to clearly state the compensation components that will become due upon a termination. Generally, all compensation, including bonus and other incentive compensation, will become due in the event of a without "cause" termination by the employer or termination for "good reason" by the employee, and only earned but unpaid compensation will become due in the event of a "cause" termination by the employer or voluntary termination by the employee. Many employers negotiate what should be paid in the event of a termination for death or disability.

For particularly complex compensation arrangements, it can be helpful to include as an appendix to the agreement an example of the target compensation and goals required to be satisfied to achieve that target. If doing so, the attorney must include the appropriate disclaimers to avoid a claim of breach if the parameters are not met.

Cause

The "cause" provision can be the most important provision in a contract because it will often determine whether a terminated employee is entitled to the compensation and benefits set forth in the agreement. Proper definitions include objective measures, rather than subjective determinations by the company, to determine whether "cause" exists. In addition, notice and opportunity to cure curable acts that constitute grounds for a "cause" termination should be included to avoid unnecessary termination, which has a cost for both the employee and employer (including both hard and soft costs). Further, it is important to note that "cause" does not typically include poor performance; it applies to repeated failure to perform.

Common elements of a "cause" definition include:

- gross negligence or willful misconduct in the performance of the material responsibilities of the employee's office or position;

- the willful and continued failure to perform the employee's duties after receipt of written notice and an opportunity to cure such alleged cause;
- the employee's conviction of, or plea of *nolo contendere* to, a crime; and
- an act of disloyalty or dishonesty by the employee.

Good Reason

Similar to "cause," "good reason" is the provision in the contract that would allow the employee to terminate the agreement and receive the compensation and benefits that would be provided had the company terminated the employee without cause. This provision, therefore, can be extremely important when representing senior executives or companies that offer this protection.

Common elements of a "good reason" definition include:

- a "change in control" (in the ownership of the company);
- the employer's uncured breach of the employment agreement;
- a material change in the employee's reporting requirements or duties; and
- a change in the employee's office location (usually more than a specified number of miles away from the office location in which the employee works).

Non-Compete

Non-compete provisions are commonly included in employment agreements for senior executives, sales persons, and financial analysts and traders, as well as in personal service agreements (*e.g.*, for entertainers and on-air talent). As previously noted, there is a strong public policy encouraging competition and freedom to contract. Accordingly, courts will narrowly construe restrictive covenants. Generally, courts will enforce non-compete provisions that are restricted in scope and place; that is, those that restrict a particular activity within a limited geographic area. Courts will only enforce these provisions if necessary to protect a company's legitimate business interests and the provision is not harmful to the general public and not unreasonably burdensome to the employee. An employer's legitimate interests include preventing misappropriation of trade secrets and confidential customer information, and preventing competition by a former employee whose services are unique or extraordinary. A non-compete clause should be tailored to be no greater than required to protect an employer's legitimate interests, as "a covenant unrestrained by any limitations keyed to uniqueness, trade secrets, confidentiality or even competitive unfairness, is unenforceable."[2] Essentially, the court will evaluate the reasonability of the non-compete clause. To increase the likelihood of enforcement, an employer may condition the restrictive covenant upon the payment of additional consideration to the employee. Note, however, that California courts will not enforce a non-compete provision, even if narrowly drawn.

An example of a non-compete provision is: "Employee hereby agrees that during the period commencing on the date of this Agreement and ending on the __ month anniversary of the termination of your employment for any reason, Employee shall not, directly or indirectly, engage in the 'Business' on behalf of any entity or person (other than the Company or its clients during the course of your employment with the Company), either individually or in any other individual or representative capacity, including, without limitation, as employee, consultant, agent, stockholder, owner, director, partner, principal or member of any other agency, entity, or person anywhere within twenty-five miles of Employee's office location on the last day of Employee's employment with the Company (the 'Territory'), unless the Company expressly and in its sole discretion waives in writing Employee's compliance with this provision; provided, however, that nothing contained herein shall be construed to prevent you from investing in the stock of any corporation listed on a national securities exchange or traded in the over-the-counter market so long as you are not involved in the day to day business of such corporation and you do not own more than five percent (5 percent) of the stock of such corporation (a 'Permitted Investment'). The Company shall pay to Employee one-half of one-month's base salary in effect as of the date of termination for each month during which this provision is in effect."

[2] *Ashland Management Inc. v. Altair Investments NA, LLC*, 59 A.D.3d 97, 869 N.Y.S.2d 465 (1st Dep't 2008).

Non-Solicit and Non-Hire

In comparison to non-compete provisions, courts are more likely to enforce restrictions against solicitation of company clients and vendors (*i.e.*, non-solicit provisions) and restrictions against solicitation for hire of other company employees (*i.e.*, non-hire provisions). Oftentimes, a company can obtain the protection it seeks through appropriate use of these provisions, rather than risk non-enforcement of a non-compete provision.

A common non-solicit and non-hire provision would read as follows: "Employee hereby agrees that during the period commencing on the date of this Agreement and ending on the __ month anniversary of the termination of your employment for any reason, Employee will not, directly or indirectly, for Employee or another person or entity (a) solicit or attempt to solicit (i) any client doing business with the Company or doing business with the Company within the __ month period prior to Employee's termination of employment, with whom or which Employee had any contact or involvement during Employee's employment with the Company; or (ii) any prospective client of the Company whom or which is a prospective client of the Company of the date of the termination of Employee's employment and with whom or which Employee had any contact or involvement during Employee's employment with the Company; or (b) recruit, hire or solicit for employment or engagement, any person who is or was within __ months of the date such solicitation commences or occurs, as the case may be, employed or engaged as a consultant by the Company, or otherwise seek to influence or alter any such person's employment or consultancy relationship with the Company." The employment agreement should also contain a definition of "client" and "prospective client."

Blue Penciling

Another way to strengthen the likelihood that a court will enforce a restrictive covenant is to include a "blue penciling" provision in the employment agreement. This is a savings clause that authorizes a court to limit the applicable provision in time or scope to the maximum allowed in the jurisdiction, rather than render the entire provision unenforceable.

This type of provision generally provides: "If any of the restrictions on competitive or other activities contained in this provision shall for any reason be held by a court of competent jurisdiction to be excessively broad as to duration, geographic scope, activity or subject, such restrictions shall be construed so as thereafter to be limited or reduced to be enforceable to the extent compatible with the applicable law; it being understood and agreed that by the execution of this Employment Agreement, (a) the parties agree that such restrictions are reasonable and compatible with their respective rights and (b) the Employee acknowledges and agrees that the restrictions will not prevent Employee from obtaining gainful employment subsequent to the termination of employment."

Dispute Resolution

As noted herein, many employers prefer to resolve employee claims outside of the glare of the public court system. For these employers, it is necessary to include an enforceable agreement to arbitrate employee claims. There are very specific requirements for arbitration provisions to be enforceable. Such agreements should:

- broadly define the types of claims that will be subject to arbitration, including all claims arising out of the employment agreement and employment-related disputes;
- provide that the employer shall pay for the fees of the arbitrator and costs of arbitration services provider;
- include an express waiver of any right to a trial by jury of claims that would otherwise be so triable;
- authorize the arbitrator to direct the parties to conduct discovery, consider and grant summary judgment, and award attorneys' fees to the prevailing party;
- waive any right to punitive damages;
- carve out from any provision the right of the employee to file a claim with a governmental agency such as the Equal Employment Opportunity Commission (EEOC); and
- acknowledge that a court of competent jurisdiction is empowered to issue injunctive relief in aid of arbitration or with respect to other provisions in the employment agreement such as the restrictive covenants.

Other Provisions

Numerous other provisions are included in an employment agreement depending on the employer's corporate culture, the specific compensation arrangement offered to the employee, and the nature of the position. Attorneys should be mindful to include provisions concerning the employee's duties, reporting requirements and devotion of all business time to the employer, indemnification rights, change in control, confidential information, works made for hire, and, among others, the choice of law.

Designing and Implementing Compensation Arrangements

Among other things, the collapse of the financial industry in the late 2000s has produced a renewed focus on aligning employee pay with company performance. Performance-based compensation arrangements are extensively used to avert a repeat of outsized pay packages awarded to executives at companies whose share prices declined precipitously. Compensation consultants and shareholder groups routinely track public companies' pay practices. Compensation experts can be particularly helpful in determining peer groups and market data, and should be relied upon where circumstances allow. Often, board compensation committees retain their own independent compensation consultant to advise them on the propriety of management's proposals—or to create their own plans. In these circumstances, the company may also retain a consultant to design the compensation arrangements.

Quite often, the attorney preparing the employment agreements will work with the compensation consultant to understand the nature of the compensation and benefits package being offered. Except in extraordinary circumstances, it is essential that the agreement appropriately refer and be subject to the various incentive compensation plans so that the company may later modify them to meet the company's changing needs and goals. Further, the attorney should be sensitive to nuances in the compensation plan so that he or she can advise the client on expected outcomes. When necessary, employment attorneys should consult with tax attorneys to obtain specialized advice that might not be readily apparent, especially in view of Section 409A of the Internal Revenue Code[3] and the prevalence of deferred compensation plans.

Negotiating Severance Provisions in the Employment Agreement

The preparation of the employment agreement is often an ideal time to address severance, even though it can be a delicate subject. Much like a pre-nuptial agreement entered into before a marriage, it can be quite useful to agree upon the terms of a proposed separation, and hope never to have to enforce them.

Many companies use this opportunity to fix the amount of compensation to be paid to a senior executive who may be asked to depart without cause (severance should not be paid to an employee who is terminated for cause). This has become a particularly sensitive issue following overly generous severance benefits provided to CEOs of companies whose share prices had fallen dramatically during their tenure. In all cases, the employer should condition the payment of severance upon the execution of a release in the form required by the company and it is a good practice to provide a sample release as an appendix to the employment agreement. This limits the possibility of negotiation concerning the terms of the release at the time of separation.

From the employee's perspective, it is almost always beneficial to include severance in the employment agreement and thereby obtain a contractual right to the payment upon termination, rather than rely upon a company practice or policy that might be modified or eliminated. New hires are often reluctant to raise this issue during their negotiations. To address this hesitancy, I often remind employees that it is not their direct manager that

[3] "Section 409A generally provides that if certain requirements are not met at any time during a taxable year, amounts deferred under a nonqualified deferred compensation plan for that year and all previous taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income." Further Guidance on the Application of Section 409A to Nonqualified Deferred Compensation Plans, 73 FR 74380-01Thus, an agreement that would provide compensation earned in the current year and paid to the employee in a future year, such as a guaranteed bonus or severance agreement, may be considered a nonqualified deferred compensation plan. There are various means to address this regulation to avoid taxation to the employee during the current year.

they have to worry about, but their manager's manager, who will not likely act in their interest when the decision to terminate the relationship has been made. I find that this issue is best addressed through counsel.

Recent Cases and Pending Legislation

The United States Supreme Court issued a decision in 2011 that is already having strong effects on arbitration of employee class action claims. The Supreme Court ruled in *AT&T Mobility LLC v. Concepcion*[4] that the Federal Arbitration Act pre-empts California's judicial rule stating that a class arbitration waiver is unenforceable as unconscionable under California law if it is contained in a consumer contract of adhesion. This case did not involve an employment agreement, but the Supreme Court's analysis has given employers grounds to seek to enforce agreements that include waivers of employee class actions and require individual arbitration of employment-related claims. The impact of this decision can already be seen in various federal cases.[5]

Employers should consider the consequences of choosing to arbitrate class action claims rather than litigate them. Although arbitration can be less costly than litigation because of the reduced breadth of discovery usually attendant to arbitration, there will be no right to appeal certification of the class, or even the ultimate award rendered by the arbitrator except in very limited circumstances.

Apropos of these recent cases, there is still pending in congressional committee review the proposed Arbitration Fairness Act of 2011.[6] Should the Act be enacted, it would declare unenforceable pre-dispute agreements to arbitrate employment, consumer, or civil rights disputes. It would further declare that the validity and enforceability of an agreement to arbitrate shall be determined by a court, under federal law, rather than an arbitrator,

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4 *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (U.S. 2011).

5 *Dauod v. Ameriprise Financial Services*, 2011 WL 6961586 (C.D. Cal. 2011) (employees putative class action dismissed as barred by agreement to arbitrate class action claims); *Quevado v. Macy's*, 798 F. Supp. 2d 1122 (C.D. Cal. 2011) (Court granted employer's motion to compel arbitration of former employee's putative class action claim alleging failure to timely pay wages owed upon termination under California law); *D'Antuono v. Service Road Corp.*, 789 F. Supp. 2d 308 (D. Conn. 2011).

6 112th CONGRESS, 1st Session, 112th CONGRESS, 1st Session.

without regard to whether the party resisting arbitration challenges the arbitration agreement specifically or in conjunction with other terms of the contract containing such agreement. The Act would exempt arbitration provisions in a contract between an employer and a labor organization or between labor organizations. If this Act is enacted, it would be an express rejection of the Supreme Court's decision in *AT&T v. Concepcion*,[7] and have an obvious and profound impact on arbitration provisions contained in employment agreements.

Conclusion

As with all other areas of legal practice, negotiating and preparing employment agreements requires careful planning and execution. Attorneys fulfill a critical role in the process, often "securing" the business terms previously agreed upon and negotiating the legal protections that the clients may not have considered when the deal was struck. Precise attention to detail is required to ensure that all terms are clearly set forth and enforceable, should the need arise to test them in court or arbitration. Employment attorneys have an opportunity to directly affect their clients' businesses and personal livelihoods, and should treat that opportunity with the significance it deserves—and relish it.

Key Takeaways

- Include clear and specific provisions that state the intentions of the parties and will be enforceable by a court or arbitrator if necessary.
- Caution clients against providing compensation or benefits that could draw negative attention from shareholder groups or government regulators as excessive.
- Draft restrictive covenants as narrowly as possible while still protecting the employer's legitimate interests.
- Consider using employment agreements to address the terms of severance upon separation.
- Include objective terms in the "cause" and "good reason" clauses and clearly state the financial consequences of termination pursuant to those provisions.

[7] *Concepcion*, 131 S. Ct. at 1740.

Scott R. Matthews, a partner with Windels Marx Lane & Mittendorf LLP, represents employers and senior executives in transactional and litigated matters involving employment and partnership relationships. He regularly advises employers and employees with respect to the negotiation and preparation of employment and separation agreements, trade secret theft, the role of restrictive covenants, and complex compensation arrangements, and litigates and arbitrates claims involving sexual harassment and wrongful termination claims based on discrimination, retaliatory discharge, and whistleblower issues, as well as business disputes involving breach of contract and fiduciary duty, fraud, commercial real estate development, and asset recovery. Mr. Matthews lectures frequently on employment law issues at trade conferences in New York and Chicago, before professional associations in the New York metropolitan area, and at New York University, Stern School of Business.

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