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Negotiating Executive Employment Contracts to Anticipate Disputes

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1. Risks for both sides in executive departures

Executives can leave a company under their own steam, or with a decisive push from the employer, or in an amicable fashion that averts problems everyone would like to avoid. The last alternative is often tricky to engineer, since in most executive departures the legal, business, financial and personal issues have significant consequences.

For the employer, a departing senior executive can signal a public perception that the company is unstable or headed downward. If the departure is sudden, the vacuum left by the executive may be disruptive to business. The employer may have serious concerns about the executive going off to compete, solicit the company's clients and poach its employees.

For the employee, both the threat of an involuntary termination, and even the prospect of an unhappy voluntary one may leave the executive vulnerable to significant financial losses in the form of bonuses or equity left behind or forfeited. And whether there is potential scuttlebutt about a departure that can harm an executive's career, or a public reporting requirement governing the employer, the executive will want to minimize potential negative public exposure.

This paper is a practical analysis of how potential problems in a departure can be anticipated by drafting contract terms that protect a party's interests. While written from the perspective of an employee counsel, it discusses the strategies that can be used by management counsel.

Since the premise of the employment relationship in most states is the at-will doctrine, why should an employer enter into employment agreements in the first place? As a practical matter, most executives will insist on them when they are being hired, absent a calamitous economy or distressed personal circumstances. If an employer wants to recruit the executive, the employer will have to provide a workable agreement.

An employment contract gives an employer the ability to extract concessions from the executive that the employer might otherwise not get. The employer can restrain future competition and solicitation of clients and employees, specify a forum for the resolution of disputes, and set in advance the general parameters of its financial obligations to the executive, both during the contract term and once the employment terminates.

For the executive, the employment contract is critical. Most executives will want to avoid any implication of an at will relationship. They will want to have guarantees of a particular term of employment, a guaranteed salary and provisions for bonus and equity compensation, a recitation of the grounds the employer and employee can invoke to terminate the agreement, explicit financial consequences for the termination of the contract, and a provision governing how disputes will be resolved.

Thus, the easiest way to protect a party's interests when an executive departs is to think ahead when negotiating an executive's employment contract. A well drafted contract can limit the issues in dispute for both sides, minimize ambiguities, and put both parties on notice of their real obligations and their ability to enforce their rights. [1]

2. What temporal term is appropriate?

For an executive who is negotiating a contract to join an employer, a longer term will normally be more sensible than a shorter one. Not only will it naturally take time for the executive to best fill his role, but if the executive's compensation is going to be partially governed by performance goals, those goals will normally be more than short term.

At the same time, while many stock and stock option plans will have four to five year vesting schedules, it would be unusual for most executives to be able to negotiate a four to five year term. And most executives will probably not want to be bound by such a long term, unless there are (as discussed below) very liberal and financially protective exit routes. As a result, many executives seek a two to three year term.

For the executive, this could be coupled with a provision for automatic renewal, unless the employer gives sufficient notice in advance of the term expiring:

> Executive's term of employment under this Agreement (the "Term") shall commence on the Commencement Date and shall expire the earlier of a) the third anniversary of the Commencement Date, or b) the date it is terminated by Employer or Executive pursuant to the provisions of this Agreement.
>
> The Term shall be automatically extended for additional one (1) year periods on the third anniversary of the Commencement Date, and annually thereafter, unless the Executive or the Company has received a written Notice of Non-Renewal delivered no later than one hundred and

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1 This paper does not address the many issues raised by provisions concerning non-competition, non-solicitation, and confidentiality, and the compensation issues for public companies under Dodd-Frank and Sarbanes-Oxley, including clawback provisions, since that would at least triple the length of this piece.

> twenty (120) days prior to the anniversary date, pursuant to Section ___ below.

The executive should push to have the notice period for non-renewal be lengthy, particularly if the contract does not provide for an automatic severance payment if it is not renewed. Realistically, the executive will need to make professional and financial plans, and the longer the term of the contract, the more reasonable it is for the Executive to seek a longer notice period (180 days or more being appropriate in a long contract term.) The employer will want to limit the number of renewals, to minimize its obligations.

Alternatives to set terms:

The employer may not want to commit to a set term; it may prefer to agree to an indefinite term which is terminable with or without cause, but which if terminated without cause, provides the executive with a reasonable severance payment. If the executive agrees to such an arrangement, the contract should provide for the executive to invoke both not for cause and "good reason" grounds (discussed below) to resign, where the "good reason" resignation is coupled with severance.

While such a contract greatly loosens the employer's obligations to the executive, it also leaves the company vulnerable to a voluntary resignation it may not want. From the executive's perspective, unless the severance payment is substantial, this arrangement is only a small step up from an at-will relationship.

3. Title, responsibilities and reporting relationship

Let's assume that the parties have agreed on a title, perhaps after some initial back and forth. If the employer wants to preserve its flexibility in designing or changing the executive's role, it will seek language that leaves the executive's responsibilities in the CEO's or Board's discretion, as long as they are commensurate with the position. Typical employer-friendly language would be:

> During the Employment Period, Executive shall serve as the Chief Financial Officer of the Company, with the duties, authority and responsibilities commensurate with such position, and such other duties commensurate with his position as are assigned to him by the Board of Directors of the Company (the "Board") from time to time.

For the executive, this language is subject to far too much interpretation, and the executive should push to have the specific responsibilities specified in detail - and ensure that they are realistic. In that case, the employer's interest can be protected by including language that the CEO or Board can also assign the executive additional duties commensurate with the position.

Start up companies will often want particular flexibility in assigning the executive responsibilities. Language which accommodates this, but also protects the Executive from being sidelined into inappropriate tasks, would be:

> The Executive acknowledges that in keeping with the culture of an early stage growth enterprise, she may be called upon to perform tasks outside of her job description, as long as such duties are commensurate with her skills and do not unreasonably interfere with her performance or ability to perform the duties, authority and responsibilities described in Exhibit __.

The contract will normally specify a reporting relationship, whether it is to the Board of Directors (for the CEO), or an officer of the company. The Executive should resist language allowing the reporting relationship to be to that person's "designee," to guard against a substantive change in status.

Most contracts have a clause requiring the executive to devote his "full business time" or "substantially all her working time" to the executive's position. This should be coupled with a clause permitting the executive to engage in outside activities that do not interfere with her responsibilities. For example,

> The Executive may, as long as such activities do not materially interfere with the performance of the Executive's duties and responsibilities (including, without limitation, fiduciary duties), or otherwise violate the terms of this Agreement: (i) manage her personal, financial and legal affairs, (ii) continue to serve on the boards or committees that are listed on Exhibit A of this Agreement, (iii) be involved in charitable activities and boards, and (iv) subject to the prior written approval of the Company, accept appointment and serve on any board of directors or advisors of any business corporation.

4. Compensation

a. Salary

Assuming the parties have agreed on a base salary, they still need to determine whether the contract will include built-in raises. Most employers will want to leave any raises to their discretion; executives, particularly in a long-term contract, will want to guarantee increases. Increases can be set as a percentage of the previous salary or a fixed amount. A toothless minimum provision from the executive's perspective would require the Company to "review the Executive's salary annually at the anniversary of the Effective Date, provided that changes in the Executive's Base Salary, if any, shall be at the sole discretion of the Board; however the Executive's salary shall not be subject to decrease during the Term."

b. Bonus

An executive's bonus has the potential to both be a strong performance incentive and give rise to a huge dispute. The drafting of this language is critical, and must be done with reference to the law of the governing jurisdiction.

The executive will want to limit the company's discretion as much as possible. The simplest and most protective way of doing this is to guarantee a minimum bonus. Of course, from the employer's perspective, this reduces the bonus' value as an incentive for performance. On the other hand, assuming that either the contract and/or the governing law requires the executive to be employed on the date the bonus is paid, a guaranteed bonus does operate as a retention incentive.

The least protective bonus structure is to leave the bonus entirely in the employer's discretion, even if the contract purports to tie the bonus in vague, non-metric terms to the performance of the company, the performance of the executive's group, and/or the executive's own performance.

A compromise that gives the executive incentive to perform well, and gives the executive the security of knowing the parameters of a bonus award, is to tie a bonus payment to specific and objective goals or metrics. For example, the agreement can tie the amount of a bonus to the executive's group achieving specified revenue growth, profits, or client generation goals. If the Executive is sufficiently senior, it may make sense to tie bonus to the employer's overall EBIT or EBITDA. The contract can set a "target" bonus, but Executives normally need to be counseled that unless the target is tied to a specific metric achievement, it doesn't bind the employer to anything. (I often see executives who erroneously believe that their target, noted in an unfavorably-drafted contract, is a numeric entitlement.)

Often a contract will provide that the bonus is based upon goals which the parties will agree upon; the infirmity here, from the Executive's perspective, is that it postpones the setting of goals and the resulting bonus parameters until after the contract is signed and the executive is employed, removing the leverage the executive may have to push for goals he thinks are reasonable and achievable:

> The Executive shall be eligible to receive an annual bonus of up to 200% of his Base Salary, payable on or before March 15 of each year, which may be awarded by the Board of Directors or a committee thereof based on a combination of the Executive's performance and the Company's performance as measured against a written set of performance criteria to be mutually agreed upon each year. The performance criteria and bonus plan for 2011 shall be agreed to by the parties within 30-days from the effective date of this Agreement.

Bonuses can be awarded in cash, or as part of an equity incentive program that includes stock, restricted stock or stock options, which vest over time. The contract should normally refer to the governing equity plans, which specify the form of awards, vesting schedules, and conditions that might result in forfeiture (such as competition, solicitation of clients, termination for cause or not for cause, resignation, and disability).

(1) Tax issues concerning bonuses under 409A

A significant issue in the payment of bonuses is structuring the arrangement to avoid the significant tax penalties under Internal Revenue Code Sec. 409A. Sec. 409A was enacted in 2004 to curb abuses of deferred compensation arrangements in which executives defer receiving income and incurring tax liability for lengthy time periods. Both sides must consider the implications of 409A when negotiating compensation and severance arrangements.

While a detailed discussion of 409A issues would require far more material than can be included in this paper, here are the basic issues to be mindful of concerning bonus payments; other 409A issues (concerning terminations, severance payments, and change of control provisions) are noted below. The Treasury Department's final regulations are an excellent explanation of the issues, although four hundred pages long. 26 CFR 1.409A-1 et seq (April 17, 2007) at http://edocket.access.gpo.gov/2007/pdf/07-1820.pdf.

409A penalizes payments made under deferred compensation plans; a deferred compensation plan is one in which a payment "*may be*" made or completed more than two and half months after the tax year in which the employee acquires "a legally binding right" to the compensation. 26 CFR 1.409A-1(b)(1). An employee acquires a legally binding right to the compensation when the compensation is no longer subject to a "substantial risk of forfeiture."

For employers whose taxable year ends December 31, the allowable payment period -- called the "short term deferral period" -- runs through March 15 of the next year. Payments made within this time will be considered "short term deferrals," meaning they are compliant with 409A. 26 CFR 1.409A-1(b)(4). If the payments are not compliant with 409A, the tax penalties are that: 1) income is immediately accelerated and recognized; 2) there is an additional 20% tax on the income; and 3) interest is charged if the tax is not paid in the appropriate tax year.

Both the employer and employee will want to structure the arrangement --either on the way in or way out -- so it either is not considered deferred compensation, or otherwise falls into one of the exceptions from 409A.

If a bonus payment is made after the Short Term Deferral period, it will be penalized under 409A. But there are mechanisms the parties can use to avoid this:

> If the contract requires that in order to receive the bonus, the executive must be employed on the bonus payout date, then there will not be a 409A penalty, because payments that are conditioned on performance of substantial future services are considered to be subject to a substantial risk of forfeiture, and thus not subject to 409A.
>
> Bonuses which are dependent on the employer's attainment of the employer's business activities or goals (for example, the attainment of a level of earnings, equity value or a liquidity event) are also considered subject to a substantial risk of forfeiture, and thus outside 409A.
>
> Bonuses which the employer could reduce or eliminate are subject to a substantial risk of forfeiture.
>
> Bonuses the payment of which are dependent on the employee being involuntarily terminated without cause are considered subject to a substantial risk of forfeiture and thus not subject to 409A. However, see the limitations concerning payments in connection with separations from service, Sec. 5(c) below.
>
> But note: Bonus payments which are subject to a condition of the executive "refraining from the performance of services" (i.e., the executive not competing) are not subject to a substantial risk of forfeiture, and thus are subject to the mandatory two and a half month short term deferral limitation.

See examples to 26 CFR 1.409A-1(b)(4). The regulations also describe how discretionary bonuses are treated for 409A purposes when the employee has the ability under the bonus plan to defer the payment of the bonus.

Agreements will commonly have a 409A savings clause, noting that the payments are intended to be either compliant with 409A or not governed by it, and that if a provision of the agreement would require a payment to be made in violation of 409A, the agreement shall be modified, and the payment shall be made, to ensure compliance:

> This Agreement shall be interpreted and administered in a manner so that any amount or benefit payable shall be paid or provided in a manner that is either exempt from or compliant with the requirements of Section 409A of the Internal Revenue Code and applicable guidance and regulations issued thereunder.

c. **Equity**

An executive's most valuable compensation may be in the form of equity: stock options, restricted stock, unrestricted stock awards, Stock Appreciation Rights (SARS), performance shares or phantom stock. An established company will have equity plans governing these awards, and for most forms of equity, the executive would receive an award letter, an equity agreement to be signed and a copy of the equity plan. The equity plan and agreement will detail the form of awards, vesting schedules, forfeiture conditions and exercise requirements. Therefore, the issues available for negotiation in the employment contract may be limited to the type and quantity of the equity award. If the executive is negotiating with a start up company, and the plans are not in place at the time, the executive should press for those plans to be memorialized before the contract is signed.

An executive's equity interests may or may not be subject to the tax penalties under Sec. 409A. In general, stock or stock options are not considered deferred compensation and therefore not subject to 409A if they 1) are granted with an exercise price not less than the fair market value; 2) are vested on the date of the grant; and 3) are stock of the employer or a corporate parent. (Of course, for most awards, vesting will be over several years.) The regulations provide for permissible valuation methods for equity interests in both public and private companies. Incentive stock options under IRC 422, and options under an employee stock purchase plan under IRC 423 are not subject to 409A. 26 CFR 1.409A-1(a)(5) et seq. The regulations detail the treatment of other equity interests.

d. Benefits

"Fringe" benefits are not fringe-like at all, and are a valuable part of an executive's compensation. During the negotiation, the executive should press for these benefits to be specified in the agreement, because many employers prefer to simply state that the Executive “shall be entitled to the benefits the Company makes generally available from time to time to its employees occupying executive positions, in each case in accordance with the terms of those benefit plans.” It is far preferable for the executive to have the employer commit to the specific benefits to be provided, with employer and employee contributions noted: Health insurance, life insurance, short and long term disability insurance, 401(k) and profit sharing plans, cafeteria plans for health insurance costs, vacation and holidays, car allowance, and payment of housing, relocation, tuition and tax preparation expenses. While the employer will want to reserve its right to modify the benefit plans, the executive should press for language providing that the type and level of benefits specified will not be altered.

5. Termination

Once the basic business terms are set, the legal issue that presents the most likely ground for contention in any contract negotiation is how the contract can be terminated and what are the consequences of a termination. The employer will want to maximize its discretion in terminating the executive’s employment, minimize the executive’s ability to terminate the contract, and minimize the payments it must make to him after a termination. The executive will want to limit the employer’s discretion in a termination, broaden his ability to resign, and maximize the financial benefit he may have if the contract is ended.

a. Termination by the employer without cause

From the executive’s perspective, the contract should not include a provision permitting the company to terminate his employment without cause, unless the company commits to a substantial severance payment, lengthy notice, payment of bonus awards and continued vesting in equity awards. After all, the executive will argue, a termination without cause is really one unrelated to the executive’s fault or performance, and so the executive should receive the continued benefits he would have received under the contract for a substantial period of time.

The employer’s counter argument is that a termination without cause is not necessarily one without fault. Particularly when the executive has negotiated a restrictive definition of “cause,” the employer may still want to terminate “without cause” based on personal or business conflicts, the executive’s underperformance, or disagreements over business matters, either substantive or stylistic.

“Without cause” is really the catch-all for the employer’s desire to cut costs, re-organize, “go in a new direction,” eliminate a business unit, or terminate an executive who is seen as a disappointment, but whose perceived faults do not rise to the high level of “cause” included in most contracts. Or, the company may terminate without cause because it prefers to avoid a conflict over "cause," and provide the Executive a face-saving transition.

A termination without cause should be coupled with a reasonable notice period to the executive. The executive will want time to prepare for the move, and the employer may want the executive's cooperation in transitioning his responsibilities and knowledge to a successor.

(1) Payments for not-for-cause terminations

If executive should be compensated for a termination without cause, what should that compensation be? The executive's goal will be to get the full benefit of his bargain: payment of continued salary, bonus and benefits for the remainder of the contract term, and continued or accelerated vesting in equity and deferred compensation.

On the other hand, the executive may want to be cautious in seeking such a provision, since if the remaining contract term is lengthy enough, the employer will have a strong motivation to characterize a termination as one for cause, in order to avoid incurring a burdensome financial obligation.

The employer's goal will be to incur the least financial consequences for a not-for-cause termination, but tempered by its desire to recruit the executive and not leave him feeling, as he joins, that the employer is unreasonable or cavalier. If the employer takes an extreme position on this issue, it may seriously compromise the positive note on which that both sides would like the relationship begin.

Typical contractual severance arrangements include payments of six to twelve months of salary and full benefits; payment of a pro rata bonus for the year in which the executive is terminated; payment of COBRA benefits for some period of time following the severance period; and vesting in equity that would otherwise vest during the severance period. The most senior executives will have far more generous terms.

> The Company may terminate Employee's employment under this Agreement without Cause and for any reason or no reason by giving sixty days notice in writing to Employee. If the Company terminates Employee's employment without cause, Employee shall be paid "Severance" during the "Severance Period" as such terms are defined in the following sentences. "Severance" shall mean payments at Employee's base salary rate of $________ per year in accordance with normal Company payroll practices, withholding all taxes as mandated by law, along with applicable deductions for employee contributions to employee benefits. The Severance Period shall be from the termination until the earlier of either (i) one year from the date of the termination; or (ii) the

> end of the Initial Term of this agreement; provided however that such Severance Period shall not be less than six months.
>
> During the Severance Period, except as provided in this paragraph, Employee shall also be entitled to continue to participate in all Company employee benefit, incentive commission, bonus, deferred compensation, equity and incentive compensation plans in which he participated immediately prior to such termination without cause, notwithstanding any term of such plans to the contrary.

Counsel for the executive should be careful about the above language providing that the executive will continue to participate in bonus and equity plans notwithstanding the terms of those plans to the contrary. Those plan terms must be examined regardless. What does "participate" mean, as a practical matter? Can the executive rely on a bonus, or will he not receive one for the current year because he was not employed on the date the bonus is paid out? Will his participation in equity plans mean that he will continue to vest in equity, or must he be an active employee in order to do that? If there is any doubt about what the executive will receive, the payments should be specifically spelled out in the contract:

> All unvested stock options and restricted stock held by Executive as of the termination date pursuant to the Company's 2010 Equity Participation Plan shall vest automatically on the termination date. A description of such shares is attached as Exhibit A.

The employer may want to tie severance and equity payments to continued non-competition and non-solicitation obligations, particularly if the equity plans do not contain that language.

b. Termination for cause

(1) What is cause?

How the parties define "cause" may be the most critical drafting issue. The Executive will want "cause" to be a high threshold, so that it requires a far greater showing than dissatisfaction with his performance. He will also want both notice and an opportunity to cure cause allegations before they entitle the employer to terminate the contract. The employer will want to maximize its ability to find cause, will want to limit the types of breaches which are curable, and will want to require the executive to rapidly cure them (which may really mean no cure is possible.)

Common grounds for cause, which may also be subject to a cure period, include:

> 1) The Executive's failure to make a good faith attempt to perform her duties with respect to the Company or any of its subsidiaries or affiliates that are reasonably requested by the Company
>
> > This language is executive-friendly, since the focus is on whether the executive has made an effort to perform her responsibilities, not whether she has been successful.
>
> 2) Gross negligence by the Executive which causes, or which would reasonably be expected to cause, the Company material harm
>
> > The use of "gross negligence" raises the threshold to require more than the making of errors or mistakes, and the "material harm" language removes some of the subjectivity from a determination of cause.
>
> 3) The Executive's willful disregard of any reasonable and lawful written instruction from the Company's Board of Directors or any other person to whom Executive reports, if such failure or disregard has a material adverse effect upon the Company.
>
> > The inclusion of "willful" again precludes negligence as a ground. The requirement that the instruction be reasonable and lawful is an important limit on the employer's discretion. It also sets the stage for the executive to claim a breach based on a termination for whistleblowing activity under SOX, Dodd-Frank and applicable state law. The materiality language prevents the employer from initiating a cause termination based on minor disagreements which do not truly impact the employer's business.
> >
> > Contracts often include insubordination as a ground, to similar effect. In either case, the executive may want to push for language requiring multiple acts, for example "repeated willful disregard" or "repeated insubordination."
>
> 4) The Executive's willful misconduct in the performance of her duties with the Company, which has a material adverse effect upon the Company.
>
> > This is a high bar, particularly because it is limited to willful misconduct in the Executive's performance of her duties, and contains a materiality requirement. The employer may seek to strike

those qualifiers, so that it can terminate the executive for acts outside of the executive's performance which reflect poorly on the company.

If the contract includes willful misconduct as a cause, the executive will want to guard against a termination for insubordination or misconduct which is based on the executive's good faith refusal to commit an improper act, or the executive's compliance with a subpoena or regulatory directive. For example:

> "Cause" shall not include or be predicated upon any act or omission by the Executive, which is taken or made either (a) at the direction of the Board of Directors; (b) in good faith, under the Executive's reasonable belief that the act or omission was in the best interests of the Company; (c) pursuant to the advice of the Company's counsel; or (d) to comply with a lawful court order, directive from a federal, state or local government agency or industry regulatory authority, or subpoena.

5) The Executive's material violation of any securities law which violation has, or may reasonably be expected to have, a material adverse effect upon the Company.

For the executive, the materiality requirement is important. Similar provisions allow the company to terminate the executive for violation of the rules of regulatory bodies governing particular professions: for example, FINRA regulations governing financial services executives, and Medicare, Medicaid and state regulatory provisions governing medical professionals. These provisions should be drafted to prevent an insignificant or unintentional regulatory violation from morphing into Cause.

6) Executive's conviction of, or pleading guilty or *nolo contendere* to, a felony or a crime involving moral turpitude, fraud, or embezzlement.

This clause is commonly included without discussion, although it is likely that the parties haven't focused on what is a crime of moral turpitude. Normally the Executive's counsel does not want to be negotiating over whether a particular crime is one of this nature, but it is an issue to consider. Of course, employers may want to loosen this language to permit termination upon indictment.

7) Any willful, material breach by the Executive of the provisions of this Agreement governing confidential or proprietary information, trade secrets, non-competition, and non-solicitation of clients or employees [this language should refer to specific paragraphs of the contract].

> The willfulness and materiality requirements are important here, so as to preclude termination for an unintentional and minor infraction concerning confidentiality. Of course, employer's counsel will rightfully ask: What is a non-willful and non-material act of competition and solicitation?

8) Use or abuse of drugs or alcohol which materially interferes with the Executive's performance of her duties with respect to the Company or any of its subsidiaries or affiliates.

> The qualifier for "material interference" is to bar a termination based on merely uncouth behavior. Sometimes the language is "habitual drunkenness."

9) Any material breach by the Executive of this Agreement that is not promptly remedied upon receipt of written notice of such breach from the Company.

> From the Executive's perspective, this clause makes the negotiation of many of the above terms superfluous, and should be struck. At the least, it should be modified to require that the breach have an actual adverse impact on the company's business, and be coupled with a stronger cure provision (discussed below.)

10) Any breach by the Executive of the Company's Code of Conduct, Employee Handbook, or written policies, which is not promptly remedied upon receipt of written notice of such breach from the Company.

> From the Executive's perspective, this clause should be struck. Normally Codes of Conduct, employee handbooks and written policies are far broader and more inclusive than any Cause definition in an employment agreement. This language gives the employer extraordinarily wide latitude to terminate the executive on minor grounds or based on company policies which the Executive, as a practical matter, might not even know about. If the clause is not struck, it should be paired with strong requirements for materiality, willfulness, repeated violations, and a substantial opportunity to cure.

(2) Notice and cure requirements

Normally "cause" provisions are paired with a mechanism giving the executive notice of the alleged violation and an opportunity to cure it. For both parties, this makes eminent sense. The executive will want to know if there is a problem and may want to correct it. The employer may want to put the executive on stern notice but retain the ability, with some possible face-saving, to continue the relationship if the problem has been solved (although I have only seen this happen once).

In negotiating a notice and cure provision, both parties will recognize that there are some breaches that cannot be cured: Conviction of a felony, an act of competition or solicitation, material breach of confidentiality, and, arguably, willful misconduct or gross negligence. Most other breaches are capable of cure, or at least the executive deserves the opportunity to do that. A reasonable provision is:

> In order to terminate the Executive's employment for "cause" under Paragraphs __ [specify paragraph numbers of curable breaches], the Company must first give Executive written notice of the grounds constituting cause, describing in reasonable detail the date, place and underlying facts constituting cause. If Executive does not cure such alleged breach within ten business days following Executive's receipt of the notice, the Company may terminate Executive's employment for cause by providing notice to the Executive in writing.

How much time the Executive will have to cure a breach may depend on the nature of the breach, so the parties may negotiate specific time periods related to specific breaches. For example, an allegation that the executive has failed to make a good faith attempt to perform his duties should have a longer cure period than an allegation of failure to follow a directive of the Board of Directors.

(3) Consequences of termination for cause

Normally, a termination for cause will deprive the executive of severance, unpaid bonuses, and certain equity interests he might otherwise receive. The employment contract will describe the financial consequences concerning severance and bonus, and may refer to equity consequences, although those may simply be governed by the equity plans and agreements. Commonly the executive will cease to vest in unvested equity and even forfeit shares which were previously vested.

The executive should be paid salary and benefits through the date of termination. The remaining unpaid compensation will be the object of the executive's breach of contract claims that follow.

c) Tax implications of involuntary terminations under 409A

Normally, severance payments are subject to 409A, unless the payments meet the definition of a short-term deferral. However, separation payments that do not meet the short-term deferral requirement will still be exempt from 409A if :

a. they are in connection with an involuntary separation from service (which includes certain Good Reason resignations, as discussed below), or they are made in connection with an employer-sponsored Window Program (in which employees are offered separation pay in exchange for a resignation, and the offer is open for no longer than a year); *and*

b. they are made no later than December 31 of the second calendar year after the calendar in which the separation takes place; *and*

c. to the extent they are no greater than the *lesser of either* (i) twice the employee's annual rate of compensation for the year prior to the separation or (ii) the maximum amount of compensation that may be taken into account for qualified retirement plans under IRC 401(a)(17) -- which in 2010 was $245,000.

See 26 CFR 1.409A-1(b)(9)(iii).

Specified senior employees of public companies are subject to a mandatory six month delay in the payment of deferred compensation. The employer must identify the specified employees annually. Specified employees are those who own more than 5% of the stock during the year; or own more than 1% of the stock and who earned more than $150,000 during the year; or are the fifty most highly compensated officers who earned more than $160,000 during the year ($160,000 in 2010). (The number of officers to be named varies with the number of employees, and the "officer" designation refers to authority rather than title.) 26 CFR 1.409A-1(g)

Note that the six month delay only applies if the amounts are deferred compensation under 409A. If the payments are exempt from 409A because they are part of an exempt separation plan or because they qualify for short-term deferral, the six month payment delay does not apply.

Settlements or awards based on bona fide legal claims:

Compensation paid based on an award or settlement of a bona fide legal claim is not considered deferred compensation under 409A to the extent the award or settlement resolves a claim based on wrongful termination or employment discrimination (as well as FLSA and Worker's Compensation claims). Note that this exception only applies to damages paid as a result of the claim; it does not apply if the payment would have been deferred or made even without the employee's release. 26 CFR 1.409A-1(b)(11).

d) Termination by the executive for Good Reason

The executive will want some reasonable mutuality concerning the ability to terminate the relationship, and therefore most contracts contain provisions outlining the grounds on which the Executive can resign "for Good Reason." A Good Reason mechanism allows the executive to quit, but be treated as if he had been terminated without cause – meaning that he will receive the severance, bonus, benefit and equity compensation the company must provide in those circumstances.

The Good Reason provision will require the Executive to give the employer written notice of the grounds constituting good reason, and give the employer an opportunity to cure them. The executive is normally required to provide notice within a stated time period after he becomes aware of the facts underlying the breach, to prevent the executive from silently accumulating Good Reasons as they snowball. If the company cures the alleged breach, the Good Reason evaporates, and the executive cannot invoke it:

> The Executive may terminate her employment under this Agreement for Good Reason, upon written notice to the Company setting forth in reasonable detail the facts and circumstance giving rise to the purported Good Reason within thirty (30) days of the initial discovery thereof; provided, however, that the Company shall have thirty days to cure any condition alleged by the Executive in such notice to constitute Good Reason. Good Reason shall mean:
>
> (i) the diminution in Executive's titles or position; a material diminution in her authority, duties or responsibilities; or the assignment to Executive of ongoing duties and responsibilities materially inconsistent with the Executive's position;
>
> (ii) The Company's failure to make salary payments required by Par. __ without the Executive's consent, the bonus payments required by Par. ___ or the stock option grants required by Par.___, except as otherwise permitted by this Agreement;
>
> (iii) a reduction in the Executive's Base Salary without the Executive's consent;
>
> (iv) the assignment of Executive to report to an individual other than the Chief Executive Officer or his successor; or

> (v) the relocation of the Company's office to which the Executive is required to report to a location more than fifty miles from the Company's current office in New York City.

Other common Good Reasons include the failure of a successor entity to assume the obligations of the employment contract, and "the Company's material breach of a provision of this Agreement," – although this ground may be too broad for most employers.

To avoid penalties under Sec. 409A based on payment of severance for a Good Reason resignation, the parties will want to track the Good Reason definition in the regulations, and comply with the regulations governing minimum notice and cure periods. 26 CFR 1.409A(1)(n)(2).

e) Termination by the employer for disability

Both parties have an interest in specifying what happens to the relationship if the executive becomes disabled and so cannot perform his job. They recognize that there will be some period of time after which the executive's absence will create a burden on the employer. Provisions for a disability termination commonly treat the termination as if it were one without cause, although they may provide for less than the full severance benefits the executive would receive in a not for cause termination.

A common disability period is four to six months, either continuous or intermittently over a year. The clause will take into account that the executive may receive substantial short or long term disability payments under the employer's disability benefits plan, and offset severance payments by the amount of disability benefits.

A common provision describes what happens if there is a dispute between the employer and executive over whether the executive can perform his role. Under this clause, the disability determination is normally made by an independent physician picked by the parties; this doctor would examine the executive and report his findings, which would be binding. There may also be determinations by two physicians picked by the parties followed by a third physician.

> The Company shall have the right to terminate the Executive's employment under this Agreement for Disability. For purposes of this Agreement, "Disability" means any physical or mental illness which has rendered the Executive unable to perform her material duties hereunder for an aggregate of one hundred and eighty days during any period of twelve consecutive months [or: 120 days in six months].

Most contracts do not take into account the employer's obligation to engage in the interactive process concerning reasonable accommodation under the ADA and state or local disability discrimination statutes; they simply terminate employment after a period of disability, and provide for disability and severance payments.

f) Change of control

Many agreements contain change of control provisions. There are two types: single trigger and double trigger, and the double trigger is far more common. The double trigger provides for substantial payments to the executive if there is a change of control and the executive is either terminated, or resigns with Good Reason, within a stated period of time after that. With a double trigger provision, the new employer has an incentive to retain the executive and treat him well. The single trigger provisions simply provide for a payment upon a change of control. To avoid penalties under Sec. 409A, the definition of "change in control" should track the definition in the regulations. See 26 CFR 1.409A-3(i)(5)

6. Non-competition, non-solicitation of clients and employees, confidentiality, proprietary information and trade secrets

Volumes have been written on these topics, and the reader is advised to refer to them for the most complete guidance.[2] Concerning non-competition and solicitation, the executive will want to press for reasonable time limits and a narrow scope of competitive activity, keeping in mind industry norms and state-specific caselaw. Once the contract is signed, it will be difficult for the executive to get the employer to waive these restrictions on a termination of employment, without an unusually strong legal claim.

Therefore, the time for an assertive negotiation on these points is now, when the employer (the executive hopes) is strongly motivated to close the deal. Since most employers have a countervailing legitimate interest in not having a former employee compete and poach other employees, it is likely that such provisions will be included in the agreement, although their scope will be a compromise.

7. Non-disparagement

Employers normally include a non-disparagement provision, covering the contract term and "any time" in the future. The employee will normally seek mutuality, although many employers are only willing to agree, in a subsequent severance agreement, that specified individuals will not disparage the employee after a termination. The

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[2] See particularly the encyclopedic BNA treatises edited by our expert colleagues Arnold Pedowitz and Robert Blackstone, along with Brian Malsberger and Samuel Brock.

executive's non-disparagement (and confidentiality) obligations should be phrased so that the executive can discuss his responsibilities and accomplishments in the position during the course of a subsequent job search, without fear of breaching the agreement.

8. Assignment

Typically the employer will want the ability to assign the contract to an acquiring entity. The executive, in return, may seek a change of control provision, with a double trigger, providing generous severance payments if he is terminated or if he resigns for good reason after a change of control.

> The Executive shall not assign or otherwise dispose of this Agreement or any of her rights, interests, duties or obligations under this Agreement without the prior written consent of the Company, except that amounts due to the Executive shall be paid to the Executive's estate or designated beneficiary upon his death. The company shall have the right to assign this Agreement and its rights, interests, duties and obligations hereunder to any Company Successor (as defined below). Upon such assignment, the rights, interests, duties and obligations of the Company under this Agreement shall become the rights, interests, duties and obligations of the relevant transferee. This Agreement is for the sole benefit of the parties hereto and not for the benefit of any third party. For purposes of this Agreement "Company Successor" means any Person who succeeds (by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Company.

9. Remedies

The parties will have to choose between litigation or arbitration, although normally the contract reserves the employer's right to litigate disputes concerning competition and confidentiality. If the choice is arbitration, counsel should keep in mind the rules of the potential forums (AAA, JAMS, CPR, FINRA), which will provide for either a single or tri-partite arbitration panel, limits on document production and depositions, and allocation of attorney's fees and arbitration costs. To the extent the parties want to vary those rules, the contract is the place to do that.

From the executive's perspective, disputes over compensation and cause / not-for-cause termination are better suited to arbitration than claims of employment discrimination, which a plaintiff will normally want to be heard by a jury. Normally the contract will provide for all disputes (other than those concerning breach of the non-competition and confidentiality clauses) to be heard in the same forum.

Executives negotiating an arbitration clause may want to provide for a single arbitrator, rather than a tripartite panel, to avoid unnecessary expense, delay and logistical problems. They should ensure that an award of reasonable attorney's fees to the prevailing party is provided for either in the contract or the rules of the forum. The employer's choice of a venue for the arbitration may be in a distant city convenient only to the employer, which is highly inconvenient for the executive; the executive should make this a point of negotiation as well.

10. Merger clause

The contract should have a merger clause, to preclude either side from relying in a future dispute on statements made during the negotiation which are outside the contract. Of course, this is most advantageous to the employer, which will want to preclude claims based on conversations that took place before the contract was executed. (Typically, these claims are of bonus or other compensation entitlement, promises of promotion, and responsibilities not mentioned in the contract.)

> This Agreement contains the entire understanding between the parties with respect to the subject matter hereof and supersedes all prior or contemporaneous agreements or understandings between the parties with respect to the subject matter hereof. No change, addition or amendment to this Agreement shall be effective unless made by a written agreement signed by the parties hereto.

Conclusion

The choices the parties make in structuring their employment agreement will be a huge factor in what happens if the sky does fall and the relationship falls apart. If it is the employer that seeks the executive's departure, the protections the executive negotiated may not prevent him from being discharged, if the employer is highly antagonistic. But those protections can determine the leverage the executive has to resist or postpone discharge and leave on favorable financial terms. If the executive seeks to resign for "good reason," and the good reason clause is broadly and liberally worded, the employer may be more on the defensive than it likes (remembering, of course, that it is always the employer who writes the check). By thinking ahead as an agreement is being negotiated, the parties can maximize their advantages if the relationship founders.