U.S. EXECUTIVE EMPLOYMENT AGREEMENTS

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I. Background.

A. Purpose

1. Employment agreements are prepared primarily for the executive's benefit. From the executive's viewpoint, the most important elements tend to be:

(a) Specifying the form and amount of compensation.

(b) Avoiding disputes in the event of employment termination.

(c) Protecting against adverse changes in ownership, working conditions, etc.

2. There are certain benefits for the employer:

(a) Non-compete, confidentiality protection.

(b) Potential benefit to the employer of specific termination provisions.

B. Who has them

1. Generally, individualized agreements are limited to the CEO, COO and other senior management members.

2. Employment Agreements may be extended to lower tier management for various purposes including protecting managers against job loss following a takeover.

C. Ancillary Documents

1. A Summary of Key Points is usually helpful in the initial stages of negotiation for the following reasons:

(a) It can be prepared and, if necessary, signed, much more rapidly than a full agreement.

(b) Raises, and structures, issues.

(c) Can be less imposing or adversarial than using an Employment Agreement during basic negotiation.

(d) Allows the executive to focus on economic issues, leaving the attorneys to work out sometimes difficult drafting issues.

2. Separate Plans/Agreements/Side Letters.

If the Employment Agreement involves complex incentive compensation provisions, or highly individualized provisions, those provisions will generally be set forth in a separate document. Reasons for using separate agreements include the following:

(a) Employers often have a rigid policy of using standard agreements for basic employment covenants.

(b) Internal/external disclosure.

(c) Different elements of the compensation package may be negotiated by different affiliates or different departments.

II. <u>Term</u>.

A. Number of years.

B. Executive status at end of Term

1. Executive's employment is usually "at will" of the employer when the Term expires.

2. An executive employed "at will" has no contractual right to severance, yet could be separately subject to post-employment restrictions (e.g., covenant not to compete, non-solicitation, non-disclosure provisions).

3. State laws differ in protecting executives who are employed "at will" following the end of the Term. <u>Note</u>: In New York, if employment is continued after the original term of the agreement and compensation is expressed as an annual amount, there is a presumption that the agreement has been renewed for another year on the same terms and conditions.

4. From the employer's point of view it may be better to have a "term of agreement" rather than a "term of employment" to prevent automatic

renewal for another year on the same terms and conditions (including severance provisions) if neither party takes action and, nevertheless, employment continues. In such cases, the Employment Agreement should specifically state that, upon its termination, unless otherwise specifically provided, its terms do not carry over to the continued employment.

C. "Evergreen" provision

1. An "evergreen" provision involves an automatic extension of the Employment Agreement for a stated period of time unless contrary written notice is given in advance. Evergreen provisions protect the executive against "at will" employment and reduce the employer's flexibility in terminating the executive's employment.

2. There are different types of evergreen provisions based on the stated period of extension.

   (a) Extension by one day each day of the Term

   (b) Extension for one year only.

   (c) Extension for a Term identical to the original Term.

3. Evergreen provisions may limit the number of automatic renewals.

   (a) Limited renewals may allow the employer to terminate Employment Agreement without paying severance.

   (b) Non-renewal may be tied to retirement.

4. The notice period - for both the employer and the executive - to cancel the automatic extension under the evergreen provision should be carefully considered. Longer notice periods, while favorable to the executive, may create difficult transition issues for the employer.

5. Non-renewal of the Term often may be structured as a trigger for severance to provide the employer flexibility and to protect the executive against short notice periods under the evergreen provision.

6. Special grandfathering protections that may be available under tax provisions and other laws should be considered when designing evergreen provisions.

III. Position, Duties, Responsibilities.

A. Title

1. Title may affect the executive's eligibility and level of participation under the employer's employee plans and benefit arrangements.

2. Title may trigger duties provided under corporate by-laws or organization rules that are not addressed in the Employment Agreement.

B. Duties

1. Pro-Executive position: set forth the specific nature and scope of the Executive's duties in the Employment Agreement, particularly when an executive is joining a new organization following an acquisition. Allowing the employer discretion to change the executive's duties unilaterally can create a pressure point for the executive later on if the employment relationship deteriorates.

2. Executives should consider appropriate travel and reassignment restrictions when joining multi-office or international organizations.

3. Executives should avoid agreeing to provisions requiring them to spend "all time and attention" and to use "best efforts" developing the employer's business. These provisions add little in defining the executive's obligations while creating significant leverage for the employer if a dispute later arises.

4. Executive should specify in the Employment Agreement any outside activities that will be pursued during employment. These exceptions protect the executive against a subsequent claim by the employer that the executive's outside activities interfere with the executive's performance. Exceptions often include civic and charitable work.

5. Employers often require executives to seek Board consent for outside directorships and committee memberships.

6. Executives often can carve-out currently held directorships, committee memberships and personal investments in the Employment Agreement.

C. Reporting responsibilities

1. Clarify who the executive reports to – the Board, CEO, other senior executives etc.

2. Allowing for a "designee" (of the Board, CEO or other senior executive) to assign duties provides the executive little protection. Defining the chain of reporting responsibility can be a sensitive negotiating issue, particularly when an executive is joining a new employer as part of a corporate acquisition.

3. Carefully consider situations where the executive reports to one or more persons who do not determine (or may be unable to influence) the executive's future compensation.

IV. <u>Salary</u>.

A. Employment Agreements usually set forth the annual salary to be paid during the Term and the timing for salary payments (i.e., weekly, bi-weekly, monthly).

B. Provisions for reviewing the Executive's salary can significantly vary.

1. Timing: how often will salary be reviewed?

2. Reduction: can salary be reduced below the listed amount during the Term? If so, is there a limit to the reduction? Will the reduction be tied to salary adjustments for other executives?

3. Increase: can salary be increased to recognize the cost of living? If so, will the COLA be automatic or discretionary? Alternatively, will salary only be increased based on performance by executive, the employer or both? Will an increase during one year become the base salary for the next year?

4. Reviewing Body: Board of Directors, Compensation Committee or a designated officer? What process must the reviewing body undertake when considering salary adjustments?

V. <u>Signing Bonus - "Golden Hello"</u>.

A. Executives may be able to negotiate signing bonus depending upon leverage in negotiation. Key issues when negotiating signing bonuses include:

1. Timing for Payment – Executive will usually desire up front payment without restrictions.

2. Tax Consequences - Consider effect of large "golden hello" on recipient's withholding and estimated tax liabilities both with respect to the signing bonus itself and subsequent payments. Will the signing bonus be subject to payroll taxes? Can the employer treat the signing bonus as exempt from the $1 million deduction rules under Section 162(m)? Will reporting be on IRS Form W-2 or Form 1099?

B. "Golden Hellos" strongly favor the executive. Employers should place restrictions on up-front payment so that the executive cannot immediately resign and retain the signing bonus. One approach is to defer payment of the signing bonus (with earnings), and pay the deferred amounts at stated intervals or at the end of the Executive's non-compete period.

VI. <u>Annual Bonus</u>.

A. Executives will want objective criteria for determining the amount of any bonus, while employers will want to obtain maximum discretion. For publicly held companies, compliance with deduction standards under Code Section 162(m) and shareholder sensitivity on deduction issues will also play a factor in structuring bonus programs.

B. Executives should consider negotiating a minimum guaranteed bonus. Companies often grant minimum bonuses during the first year of employment. Thereafter, the Executive participates in existing bonus plans for comparable executives.

C. Larger companies often offer both annual bonus and long term incentive bonus opportunities. A typical performance period for a long-term incentive bonus is three to four years, or the initial term of the Employment Agreement.

D. Key elements of bonus arrangements include:

1. Covered group.

2. Performance targets.

3. Determination of award.

4. Vesting.

5. Pay-out provisions.

E. Performance-based bonuses vary significantly depending upon the size, industry and structure (i.e., private or publicly held) of the employer. An executive should analyze the criteria for any performance-based bonus carefully, and evaluate how and when the bonus is calculated. Criteria commonly used include EPS, ROE, revenues (gross and net) and EBITDA.

F. The employer may offer the executive the opportunity to defer bonus payments. In deferring bonus payments, the executive should consider:

1. Earnings rate on deferred amounts.

2. Security devices for the deferred amounts (i.e., "rabbi trusts").

3. When elections to defer bonus payments must be made – upon signing the Employment Agreement, before the bonus performance period or a later time? Constructive receipt tax issues will affect timing considerations.

4. Form of Payment – cash, employer stock, other?

VII. Restoration Payments for Losses Resulting from Prior Employment.

A. Executives leaving existing employment with one company to join another should evaluate their opportunity cost – that is, what benefits will be forfeited by terminating employment with the current employer. Forfeited benefits often include bonuses, equity compensation and retirement benefits.

B. An executive leaving employment should obtain a benefits statements from the previous employer illustrating any forfeited amounts when negotiating an Employment Agreement with the new employer.

VIII. Loan Programs [Prohibited by the Sarbanes-Oxley Act for public companies after July 30, 2002]

A. Larger companies, particularly publicly held corporations, offer loan programs for their executives. Common loan programs assist the executive to purchase a home (in connection with relocation) and to purchase employer stock. Employers adopting loan programs for stock should consider the possible application of Fed. Res. Bd. Reg. G. and corporate/state law limitations. See e.g., Del. Corp. L. § 143 (no limitations), N.Y. BCL S 714 (to directors, only with shareholder approval).

B. Loan terms to be negotiated include the interest rate, term, repayment schedules, and events causing loan acceleration and whether the loan will be recourse or nonrecourse.

C. Tax considerations play a key role in any loan program. Employers offering loan programs often extend funds at interest rates below prime. "Below market loans" can subject the executive to tax on the imputed value of the loan interest under Section 7872 of the Code. A minimum guaranteed bonus sometimes is used to keep the executive whole for imputed tax costs. Note that certain relocation loans are exempt from tax under Section 7872. Prop. Treas. Reg. § 1.7872-5(c).

IX. Deferred Compensation/SERPs.

A. "Deferred compensation" commonly refers to arrangements that allow the executive to defer salary, bonus or both on a pre-tax basis. Publicly held companies tend to provide deferred compensation through a separate plan covering senior management. Although less common, deferred compensation arrangements can be negotiated as a part of an Employment Agreement for a single executive.

B. "SERPs" – Supplemental Executive Retirement Plans – are a type of deferred compensation plan provided by an employer to supplement retirement benefits. SERPs usually replace compensation not covered under the employer's tax-qualified plan due to tax-law limits or other benefit formula restrictions. SERPs can also be extended to make an executive whole for forfeited retirement benefits resulting from new employment. SERPs are (i) commonly provided by publicly held companies for all senior executives, (ii) sometimes provided by mature private companies for a few key executives, and (iii) rarely provided by start-up companies.

C. Issues when considering Deferred Compensation and SERPS include the following:

1. Funding - will the arrangement be funded, and if so, how? Will a "rabbi trust" be established? Setting aside funds outside the reach of the employer's creditors will normally result in immediate tax to the Executive. Will the employer contribute its stock or other assets to the selected funding vehicle?

2. Coverage - who will be covered under the arrangement? Exemption from most ERISA requirements normally depends upon restricting coverage to only a select group of management and highly compensated employees.

3. Electing Payment - will the executive be entitled to reach deferred amounts while employed and, if so, subject to what restrictions and/or penalties to avoid adverse tax consequences? When must the executive elect the form of payment for deferred amounts?

4. Forfeiture – under what conditions will the executive forfeit deferred

amounts? Common forfeiture conditions include premature resignation and violation of post-employment obligations.

X. Equity Incentives.

A. Equity incentives often represent the most significant economic element of the executive's compensation package.

B. Types of Equity Incentives:

1. Stock Grants.

(a) Shares of stock, fully vested, are granted outright to the executive. These programs are relatively rare, and are impermissible in some states.

(b) Tax: The executive is taxed on the entire amount of the grant, in the year of the grant.

2. Stock Pay Performance Plans.

(a) These plans provide deferred awards based on achievement of corporate performance targets (e.g. ROE, gross sales, net sales, EBITDA, etc.). The award is generally determined in dollars, but payment is in stock.

(b) Tax: The executive is subject to tax in the year he or she receives the stock, unless forfeiture provisions apply even after distribution.

3. Restricted Stock.

(a) The executive is granted shares which are non-transferable and subject to forfeiture until years of service or performance goals are met. Voting and dividend rights may or may not be passed through.

(b) Tax: Unless an "83(b)" election is timely filed in connection with the grant, the executive is subject to tax on the full value of shares when the restrictions lapse.

4. Stock Purchase Plans.

(a) The executive is allowed to purchase shares currently, for either current or discounted value.

(b) Tax: If the purchase is at a discount, the executive is normally subject to tax on the discount at the time of purchase. However, a permanent restriction, such as one providing the employer a right of first refusal for a formula amount less than the market price, will effectively reduce the value per share for tax purposes, reducing the taxable portion of the discount.

5. Stock Options.

   (a) Non-Qualified.

      (i) The executive is given the right to purchase stock in the future, for a price usually determined at the date of grant.

      (ii) Tax: The executive is subject to income tax, in the year of exercise, on the exercise "spread." Later appreciation is capital gain.

   (b) Incentive Stock Option.

      (i) Functions like an ordinary stock option, but with special requirements, including: shareholder approval; minimum price (FMV on grant date; 110% of FMV for 10% shareholders); minimum holding period, maximum size of award on grant date.

      (ii) Tax: Executive is not subject to tax (and employer has no deduction) on exercise, but spread is an alternative minimum tax item, and basis on later resale remains at original exercise price.

6. Stock Appreciation Rights.

   (a) The executive is credited with rights ("SARs") corresponding to a number of shares. On exercise of a SAR, the executive is paid cash equal to the spread between stock value on the date of grant and stock value on the date of exercise.

   (b) SARs are often given in tandem with options, such that exercise of an SAR cancels one option share, and vice versa.

   (c) Tax: The executive is taxed in the year of exercise, on the exercise spread.

7. Phantom Stock.

(a) Functions much like an SAR. The executive is credited with a number of "shares" of phantom stock. These are not actual shares. The executive may exercise his or her phantom shares in the future, and receive a cash payment equal to the full value of a share of stock.

(b) Phantom shares often carry a dividend pass-through; where dividends are declared on the employer's common shares, "deemed" dividends are bonused out on the phantom shares.

(c) Tax: The executive is taxed on the exercise proceeds in the year of exercise, and is also taxed on dividend equivalents in the year received.

C. Tax consequences play a key role in structuring equity incentives. An executive will want to defer tax on the equity incentive for as long as possible while obtaining capital gains treatment. Attached is a memorandum summarizing in detail the tax rules applicable to stock options and stock awards.

D. Executives need to be sensitive to securities law restrictions that apply to their equity incentives. Insider trading rules may apply to the purchase and sale of employer securities. Black out rules also may restrict when an executive can exercise stock options and sell (or purchase) employer stock.

XI. <u>Employee Plans and Perquisites</u>.

A. Participation in all medical, dental, pension, savings, LTD, AD&D, group term life insurance plans usually will be extended to the executive. Care should be taken in evaluating medical coverage, particularly if the executive or the executive's family members have any unique health issues. It may be necessary to obtain waivers of normal waiting periods or economic equivalents if coverage is not possible under employer's medical plans.

B. Perquisites vary and depend upon the Executive's leverage and seniority. Perquisites, while usually not significant in value compared to other economic components of the Employment Agreement, often provide a significant opportunity to attract executive talent. At the same time, improperly negotiating perquisites can result in unnecessary friction between the parties.

C. Commonly offered perquisites include company cars, club memberships (including fees and dues), financial counseling, tax advice, annual physical exams, personal staff, cellular phones, outplacement services and relocation expenses.

D. Other perquisites encountered less frequently include security protection, travel on company-owned aircraft, spousal travel, and personal computers.

E. Care should be taken to define with specificity the terms under which the perquisites are being offered. Few employers are willing to continue all perquisites during severance periods.

XII. Termination of Employment.

The circumstances in which the Executive's employment may be terminated and the consequences resulting from termination should be set forth with considerable detail in the Employment Agreement.

A. Termination for Cause by the Employer

1. For "Cause" provisions usually allow the employer to (i) terminate the executive's employment at any time during the Term, (ii) avoid paying severance benefits, and (iii) forfeit most benefits accrued by the executive. Note that unpaid Salary and vested benefits under a tax-qualified plan ordinarily cannot be forfeited by the employer.

2. Employers often seek to avoid defining for "Cause" provisions with any specificity. Without a specific definition, an employer has considerable latitude to terminate the executive's employment, so long as actions are taken in good faith.

3. The executive will want to specify the actions that constitute "Cause." Ordinary negligence should be avoided as a for "Cause" termination event. As a general rule, senior executives will be able to obtain narrower "Cause" definitions than junior executives.

4. The absence of any termination for Cause provision does not necessarily prevent an employer from terminating an employee for cause.

5. Negotiating "Cause" definitions can be very sensitive. A new executive wants to focus on how value can be created for the employer, and not how severance can be paid if the new arrangement fails based, in part, on the executive's performance. The executive's attorney can be helpful in negotiating these provisions.

6. For Cause Definition – Single Trigger versus Double Trigger

(a) Single Trigger: engaging in the prohibited activity.

(b) Double Trigger: engaging in the prohibited activity plus a demonstration or good faith determination by the Board that the prohibited activity has damaged the employer's reputation or will impede the executive's ability to perform for the employer.

(c) Whether a single trigger or double trigger is used depends upon the executive's leverage and the type of prohibited activity. Felony conviction is almost always a single trigger, whereas a breach of confidentiality usually is part of a double trigger provision.

7. For Cause Definition - Criminal Actions

(a) Types of Crimes: felonies, other crimes involving dishonesty, crimes involving "moral turpitude." Executives should avoid "moral turpitude" provisions, which tend to be subjective and change depending upon the circumstances.

(b) Timing: conviction, indictment, allegation, plea of nolo contendere. Executive will want to avoid an allegation of criminal activity to form the basis of a for "Cause" termination.

(c) Reversal: Executive should be able to obtain severance benefits payable on termination without cause if conviction is reversed on appeal.

8. For Cause Definition – Dishonest Acts Against the Employer (fraud, misrepresentation, embezzlement, stealing)

9. For Cause Definition – Willful Misconduct Against the Employer

(a) Materiality: must the action actually result in material harm to the Employer?

(b) Good Faith: can the Executive's intent provide a defense against for "Cause" termination?

(c) Definition of Employer: does this include the Employer's employees (i.e. sexual harassment) or related third parties (i.e. litigation against the employer by a customer or competitor)?

10. For Cause Definition – Other Events

(a) Gross Neglect or Gross Negligence.

(b) Material Breach of Employment Agreement (including confidentiality and non-compete provisions).

11. For Cause Process

(a) Notice and Cure Rights: must the employer notify the executive and grant a right to cure before terminating employment for "Cause"? Must the notice set forth with particularity the grounds for termination? Notice and cure rights typically depend upon the type of prohibited transaction.

(b) Board Vote: must the employer obtain a Board vote before employment can be terminated for "Cause"? If so, will a supermajority be required? Will the executive have a right to appear before the Board prior to any vote with legal counsel?

B. Termination for "Good Reason" by Executive

1. Executives often seek protection against employer actions that may be viewed as a constructive termination of employment. "Good Reason" termination provisions allow the executive to resign and receive severance benefits.

2. Good Reason termination provisions often become effective after a change in control regardless of the executive's level or seniority. If a change in control has not occurred, it is uncommon for anyone except top management to enjoy Good Reason termination protection.

3. Typical Good Reason termination grounds include:

(a) Change in position, duties and responsibilities or assignment of duties inconsistent with present position, including transfer to a different division or subsidiary.

(b) Failure to elect executive as a Board member.

(c) Reduction in salary or benefits or late payments in connection with a change in control.

(d) Change in reporting responsibilities.

(e) Executive prevented from carrying out duties and responsibilities.

(i) By Board after change in control.

(ii) By controlling stockholder.

(f) Change in location of employer headquarters or of the executive's office.

(g) Terminating the executive's employment for Cause in violation of procedural requirements.

(h) Failure to assume the executive's Employment Agreement following a change in control.

(i) In appropriate circumstances, a "going private" transaction.

C. Termination of Executive's Employment by Employer without Cause.

1. Employment Agreements providing severance benefits typically set forth termination without Cause provisions.

2. Employer may seek provisions permitting cessation of severance benefits if post-termination events warrant, particularly if the executive is subject to a covenant not to compete.

D. Change in Control

1. Some Employment Agreements consider a "Change in Control" to be an event providing the executive Good Reason to terminate employment and receive severance benefits. This type of provision, often referred to as a single trigger change in control protection, usually is limited to a discrete period of time (i.e., six months to one year) following the change in control. Single trigger protection, to the extent provided, is almost always limited to top management (CEO, COO).

2. Change in control provisions can be provided for in an Employment Agreement or in a separate change in control agreement, (i.e., an agreement that only becomes effective upon a change in control). In addition, it is not uncommon to find change in control provisions in other types of agreements, e.g., stock option awards and restricted stock agreements where the terms frequently provide for acceleration of vesting upon a change in control.

3. Definition of Change in Control. Triggers may include:

(a) Certain changes in stock ownership of the employer or the parent employer (special definitions may be needed for privately held companies dealing with existing shareholders.

(b) Certain changes in Board composition.

(c) Restructuring or sale of a substantial portion of the employer's assets as a result of which the employer does not survive or the employer's principal business does not survive.

(d) Mergers and other combinations where the employer is the surviving entity but where stock ownership of existing stockholders is reduced to less than 50%. From an executive's standpoint, even a "friendly" merger should be a change in control.

E. Resignation by the Executive

1. The executive should request that resignation provisions be included in the Employment Agreement. If the executive voluntarily terminates employment in the absence of a specific provision permitting resignation, the executive may be liable for any resulting damages.

2. Resignation by the executive typically will be treated as a termination for Cause for purposes of eligibility to severance benefits.

3. Employment Agreements usually set forth the notice period for any resignation. Executive's failure to honor notice period may result in forfeiture of otherwise vested benefits.

F. Non-Renewal: Non-renewal may or may not be an event entitling the executive to severance benefits.

G. Death/Disability: Termination of the executive's employment resulting from death or disability should also be addressed in the Employment Agreement.

XIII. <u>Consequences of Termination of Employment – Severance Pay</u>

A. Elements of Severance Pay

1. Salary

(a) Lump sum payment (discounted or nondiscounted)

(b) Continued periodic payments for minimum period or, if longer, the remainder of Term.

2. Bonus/Incentive Compensation

(a) Recognizing bonus as an element of severance pay is particularly important when bonus represents a significant percentage of the executive's total compensation package.

(b) Bonus severance pay component usually consists of a pro-rata lump sum payment for the bonus performance period in which the executive terminates employment. For this type of provision, the executive should understand the pro-rata calculation payment and any minimum service requirements (i.e. remaining employed through at least half the bonus performance period).

(c) For more senior executives, the bonus severance pay component may also include an additional lump sum payment to compensate the executive for the bonus opportunity the executive would have enjoyed during the remainder of the Term but for premature termination of employment. Particular care should be exercised in designing how the bonus will be determined and paid– (i) will the last paid bonus be used or the average bonus earned by the executive, (ii) will the bonus amount be discounted for present value, (iii) will the bonus be paid up front or in tandem with a covenant not to compete.

(d) The severance pay also may include a component for equity incentives. This type of provision is usually limited to top management and programs offered by publicly held corporations.

3. Benefits Continuation

(a) Benefits that often are continued during the severance period include medical (including dental), pension, life insurance and fringe benefits. The Employment Agreement should specifically address whether any perquisites will be extended during the severance period.

(b) Special attention should be paid to medical continuation provisions and their interplay with COBRA. Issues to consider with medical continuation including the following:

(i) COBRA: will the executive (and the executive's spouse/dependents) be entitled to COBRA after the severance period, or does the severance period count against COBRA.

(ii) Policy Coverage: will the employer be able to provide the medical continuation coverage for the entire severance period? If not, what's the executive's remedy? Will the employer be entitled to settle this obligation without buying individual medical coverage?

(iii) Tax Issues: will the coverage, particularly if self-funded by the employer, be taxable to the executive?

(c) Special considerations will also be involved when considering how the executive's retirement package will be treated during the severance period. Important issues typically include the following:

(i) Tax-Qualified Plans: it is unclear whether employers can continue employee coverage under a tax-qualified plan during a severance period. If continued benefit accrual is granted under the tax-qualified plan, an immediate distribution from that plan will not be available.

(ii) SERP: will the SERP provide for additional years of service based on salary continuation during the severance period? Will final compensation be used to calculate the final SERP benefit as opposed to average compensation over the executive's career? Will the SERP payment be accelerated in a single lump sum payment?

4. Golden Parachute Protection

(a) The Employment Agreement should also address how parachute payments will be handled. Parachute payments usually include severance pay in connection with a change in control of a publicly held corporation or any other organization that does not qualify for an exemption to Code Section 280G. A full discussion of the golden parachute penalties is outside the scope of this outline.

(b) The employer will want to limit the executive's severance payments to avoid triggering a loss of deductions. The executive will want the employer to make special tax-gross up payments to cover any golden parachute excise taxes (including income taxes and excise taxes on the gross-up) triggered by the severance pay.

(c) Employment Agreement provisions should address who will make calculations under the parachute provisions and how controversies with the IRS will be handled.

5. Length of Severance Period

(a) The length of the severance period offered by the employer depends on several factors, including the executive's position, the industry and the Employer's size. Many employers rely on compensation consultants to evaluate appropriate severance pay periods.

(b) The executive will need to evaluate his need for severance protection as part of the total value of the compensation package. Senior executives with substantial cash and equity compensation packages that may prove difficult to replace usually will place a more significant value on severance. In contrast, severance will be less important for junior executives at start-up companies who rely primarily on equity compensation.

(c) The length of the severance period may be cut-off, either in whole or in part, if the Executive commences other employment as discussed below.

B. Offset Provisions.

1. Employer may seek to offset severance benefits against the executive's income from subsequent employment.

2. Offset may be full (any employment income terminates severance benefits) or partial (employment income reduces severance on a benefit by benefit basis). Partial offset provisions provide a greater incentive for the executive to find new employment.

3. Offset may also be structured to apply to only a specific portion of the severance period.

4. Other offset design issues include the following:

(a) Does deferred compensation from subsequent employer count?

(b) Do earnings from self-employment count?

(c) Does the executive have an obligation to seek new employment and, if so, is he only obligated to seek employment in a "comparable" position with a "comparable" employer. Will the noncompete provision effectively limit the executive's ability to mitigate damages?

C. Obligation to Mitigate Damages.

1. Some employers will seek to require the executive to mitigate damages by seeking comparable employment.

2. Actual use of mitigation provisions is not common. Most executives are unwilling under any circumstances to accept mitigation provisions.

D. Other Matters.

1. Payments should be specified as severance payments, liquidated damages or both and not in the nature of penalty. It should also be made clear that the parties intend that the payments are intended to include any "consequential damages" to preclude a challenge that unmitigated damages are in the nature of a penalty.

2. Executives should request a prompt payment clause.

3. Employers should negotiate that severance payments are the executive's only remedy for breach of any employment obligation.

XIV. <u>Noncompete Provisions</u>.

A. In General.

1. Absent a noncompete provision, an executive would, generally speaking, not be subject to restraints on competition following a termination of his employment. As such, noncompete provisions are for the employer's protection.

2. Courts are reluctant to enforce covenants not to compete unless there is a legitimate property interest of the employer such as trade secrets, customer lists or other confidential information that is deserving of protection.

3. Some states have statutes governing covenants not to compete. If the non-compete is "supported" by salary continuation payments, a court may be more sympathetic to the noncompete.

B. Defining the Restriction.

1. Time limits.

   (a) Only while termination payments being made.

   (b) During remainder of employment term.

2. Geographic limits.

   (a) Global, national, regional.

   (b) Within specified radius of former employer's places of business.

3. Competing entity.

   (a) Ownership restrictions.

   (b) Exceptions for investments acquired prior to becoming employed.

   (c) Product line restrictions.

   (d) Exceptions for investments in publicly held companies.

4. "No raid" of employees of present employer.

   (a) Exception for personal secretary.

   (b) Exception for discharging employees while employed if such action is in best interest of employer.

5. Anti-takeover provision: executive agrees not to engage in take-over activities relating to his former employer.

6. Executive to make self available after termination for assistance in litigation etc.

7. Limits on employer's lines of business that the executive had access to confidential information.

8. Applicability of provision following termination without cause or termination by executive for good reason.

B. Employer will retain right to injunctive relief to enforce confidentiality and noncompete covenants. The executive sometimes will be able to limit employer's remedies for breach to nonpayment of severance amounts.

C. “Blue Pencil” provisions may allow a court to cut back if covenant found unenforceable.

XV. Confidentiality Provision

A. Generally without time limit.

1. Provide exceptions for court ordered disclosures, etc. and disclosures in ordinary course of business, such as to accountants, regulatory authorities, etc.

2. The executive should determine whether breach of confidentiality provision provides for cause termination grounds.

B. Return of documents.

1. Definition of "document” can be quite important, particularly in "hi-tech" situations.

2. Exception for personal documents, e.g., personal diaries and notebooks.

XVI. Dispute Resolution

A. Arbitration.

1. Is arbitration appropriate?

(a) Arbitrators tend to compromise.

(b) An arbitrator’s decision will be final and conclusive, and rarely subject to judicial review.

(c) Arbitrators tend to “split the difference” and reach compromise.

(d) Arbitration not necessarily less expensive than litigation.

2. Executive will want to retain flexibility to litigate based on the circumstances at termination of employment.

3. Stock exchange employers will require (and it may be required) that arbitration be in accordance with applicable exchange rules and procedures which are generally favorable to the employer.

4. Other Issues.

   (a) City for arbitration.

   (b) Number of arbitrators.

   (c) Rules for arbitration.

B. Costs and Expenses

1. Executives should negotiate cost and expense provisions that protect their ability to enforce contract claims. An employer will almost always have more resources (i.e., money, personnel, time) to contest a claim by an executive. Without adequate enforcement protections, the executive may not be able to realize fully the claims' value due to legal fees, the economic loss due to delayed payment of benefits and other factors.

2. Issues to consider include the following:

   (a) If court action is only remedy, will the executive's salary and benefits continue until the issue is resolved?

   (b) Will the executive be entitled to an advance of legal fees and, if so, on what basis?

   (c) Will the executive be entitled to payment of legal fees, costs and expenses regardless of the outcome? If not, will the payment be made if the executive substantially prevails or has a good faith basis for the claim?

   (d) If the executive is required to prevail in order to be reimbursed, what if the executive prevails on some claims but not all claims?

   (e) Will there be a cap on legal fees? Will there be a "reasonableness" standard? Should a billable rate per hour be included for legal fees?

   (f) Under what circumstances, if any, would the executive be responsible for the employer's legal fees, costs and expenses?

(g) Will the employer be required to pay interest or a financial penalty to the executive if the executive substantially prevails against the employer?

3. If possible, an executive should try to ascertain in advance an employer's prior position on costs and expenses for other comparable executives, as some employers strongly object to these types of provisions.

XVII. <u>Successors and Assigns</u>

Company to successor.

1. Pro-Executive Position: the employer's obligations may not be assigned or transferred except pursuant to a merger or consolidation in which the employer is not the continuing entity, or a sale or liquidation of all or substantially all of the assets of employer, provided the assignee or transferee is the successor or all or substantially all of the assets of the employer and assumes its obligations.

2. The executive's objective is to prevent the assignment to a "shell" corporation or an entity with insufficient assets to make good on employer's obligations to executive. Another approach is not to permit assignment by employer unless executive consents thereto in writing. Exceptions may be created for employer assignments within a controlled group of companies if employer agrees to remain liable after assignment.

3. Employer to take all actions it legally can to have successor assume obligations. Failure to comply with successor provisions can be treated as an event triggering severance obligations.

B. The Executive should not be allowed to assign the executive's duties.

XVIII. <u>Governing Law - Jurisdiction</u>.

A. Employment Agreements almost always provide the law that is intended to apply. Jurisdiction provisions should include that the selection of state law shall be "without reference to principles of conflict of laws".

B. Jurisdiction provisions frequently are overlooked by the parties. Nevertheless, they should be carefully reviewed, particularly when the executive is employed in one jurisdiction and the employer's headquarters are in a different jurisdiction. For example, covenants not to compete are not enforceable in California.

C. Jurisdiction should also be carefully considered In the case of a non U.S. corporation with few or no assets in U.S. In this case, the executive, at a minimum should negotiate for the employer to submit to jurisdiction of the U.S. courts and service of process.

XIX Legal Fees – Contract Negotiation

A. Senior executives often can negotiate for the employer to pay for all or a portion of the executive's legal fees related to the review and negotiation of the Employment Agreement.

B. It may be possible for the employer to pay the executive's legal fees without such payment being treated as taxable income to the executive under certain circumstances. This situation often is presented when the employer is acquiring a new key executive. If the executive seeks non-taxable treatment, the employer should pay the fees directly to the executive's counsel.

XX Survivorship.

If a term of employment, as distinguished from a term of the agreement, is involved, certain provisions, e.g., confidentiality, noncompetition, and obligation, if any, to make severance payments should survive the termination of employment. If such a provision is not expressly included, a court could construe an agreement to continue beyond the term of employment to the extent reasonably necessary to carry out the post termination provisions of the agreement.

XXI. Representation by Employer that Employment Agreement is Valid, Enforceable and Binding.

A. That it is authorized and empowered to enter an agreement.

B. That person signing agreement or on behalf of employer is authorized to do so.

C. Opinion of local counsel if state other than New York is involved.

D. What internal approvals are needed for the contract?

1. Officer of the employer only?

2. Board compensation committee approval?

3. Full board approval?

4. Should contract be ratified by successive boards?

XXII. Freedom to Contract Representation by Executive.

A. This representation is particularly important if the executive was previously employed by a competitor. If there is an employment contract, does it contain a provision permitting employee to voluntarily terminate employment?

B. Some employers are now requiring executives to make a representation of good health or agree to undergo a physical examination.

C. Consequences if representation fails.

1. Breach of agreement.

2. Considered as an event justifying termination for "cause."

D. Does new employer may be liable if the executive is subject to a negative covenant yet nevertheless signs an Employment Agreement.

XXIII. Indemnification.

. A. Approaches to indemnification under state law differ. In some states the statute directly limits the dollar amount of a director's liability and/or raises the standard by which liability is to be measured. In other states, e.g., Del., N.J., and N.Y., the statutes permit the amending of the corporation's charter/bylaws to provide, within limits, additional protection for directors. Some state statutes also provide that the language of the statute is non-exclusive, i.e., special arrangements may be made with directors in addition to the protections afforded by the corporation's charter and by-laws.

B. Executive should seek to define indemnification rights as part of an Employment Agreement. A pro-executive indemnification provision will have the following elements:

1. Indemnification will apply to all actions taken on the employer’s behalf to the fullest extent provided by law.

2. Executive will be entitled to reimbursement during any proceeding in advance for any costs (including legal fees) and expenses regardless of whether the executive is named a party to the suit.

3. Indemnification will expressly include any post-employment claim.

4. Employer will purchase D&O insurance covering the executive both during and after employment.

C. If the Employment Agreement provides for indemnification, the employer's articles of incorporation and by-laws should be examined to determine whether such articles or by-laws have been amended to provide for maximum protection afforded by current state law. At the very least, the executive should be granted indemnification as permitted by the employer's articles and by-laws as from time-to-time in effect, but no less than as in effect on the date of the agreement consistent with applicable state law.

D. Employer may balk against providing contractual indemnification protection. Only allowing indemnification protection as provided under by-laws and D&O insurance provides the employer some discretion to handle indemnification issues on a case by case basis.

XXIV. Guarantee.

A. An executive will want a guarantee by a well capitalized member of the employer’s controlled group. This may be particularly important if the contracting entity is a subsidiary that is thinly capitalized.

B. For the executive’s viewpoint, the guarantee should not require the executive to commence action against the employer. Instead, the guarantee is for payment and not collection.

C. Any guarantee, particularly for non-qualified deferred compensation, should be reviewed for tax issues.