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The Art Of Drafting Executive Employment Agreements: Part 1

By **Mark Poerio** (November 21, 2019, 5:07 PM EST)

This is the first of a two-part article that addresses issues often arising during the negotiation, drafting and review of executive employment agreements with a focus on terms, provisions and contractual language that implicate economically significant matters. Both employer and executive perspectives are presented in a discussion that tracks the flow of a typical employment agreement.

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This is intended to provide a heads-up for material issues. Due to the high stakes and complexity of these agreements, experienced legal counsel should be sought for sound and thorough advice.[1]

Introduction

After drafting or reviewing hundreds or even thousands of employment agreements, the exercise can become rote to counsel. The framework tends to be standard: Start the agreement by defining the position and the term, then address different forms of compensation, determine severance and finish up with boilerplate.

Despite the superficial standardization, employment agreements are nevertheless loaded with money issues, often tied to bonuses, equity awards and severance. High stakes can also attach to mere phrases within the agreement because there is potential both for costly stumbles and for minor changes that serve valuable purposes.

The interests of employers and executives often clash, especially in keenly negotiated agreements. Nevertheless, both parties should aim to assure that the finished product accurately and thoroughly documents their expectations. That takes forward-minded attention to money issues, potential problems and alternative solutions.

The best agreements tend to endure for many years, and the worst tend to require painful ongoing dialogue and negotiation. No one wins (except the lawyers) when parties haggle about immaterial word phrasings. There is nevertheless quite an art to assuring that an employment agreement smartly accomplishes its purposes.

Precise Versus General Terminology

Precise language and detail almost always favor — and are warranted — for the party seeking to document specific expectations. For instance, if a prospective executive wants to assure the ability to telecommute, to be reimbursed for relocation costs, to serve on multiple boards, or to receive a particular stock award grant, the terms should be spelled out as specifically as possible. The same holds if an employer has particular expectations, such as for when employment will commence, what an executive is expected to achieve, and how an executive may exit on agreeable terms.

Although generalized terms tend to favor the party who wants flexibility, ambiguous terms should be avoided. They sow misunderstandings and interfere with prompt dispute resolution. In other words, ambiguity mainly favors those paid to litigate disputes.

Getting Started Well

Position and Reporting Relationship

From the employer's perspective, general terms are preferable to maximize the employer's ability to respond to changing business conditions and expectations. By contrast, being overly specific, such as by identifying supervisors by name, could trigger unintended claims for breach of the agreement and, potentially, severance fights.

For executives, however, it makes sense to have an agreement go beyond a mere identification of title and to establish a reasonable scope for the executive's role and the associated reporting relationship. That will both document expectations and provide a basis for relief if the employer seeks to make future changes that disappoint.

For instance, changes in its business could result in new demands on the executive. If those demands fall outside the scope of the initial engagement, the executive would have leverage to negotiate for enhanced pay, or severance or other adjustments.

Commencement Date and Relocation

From the employer's perspective, when recruiting, soft promises are often made (and appropriate) regarding when an executive will start and the terms for relocation and reimbursement. Being precise in an employment agreement will enable both sides to identify mutually agreeable boundaries and reimbursement terms. If the employer will be paying significant relocation expenses, consider a recoupment clause that is triggered if the executive quits within some defined period after the move.

The anticipation of a new job often clouds executives to the significant costs and risks associated with a significant relocation. When representing the executive, it is reasonable to seek protections, both at the front end (by not underestimating the costs and by delineating the range of reimbursable expenses) and at the back end (by seeking enhanced protection if a without-cause termination occurs soon after the move).

Term

From the employer's perspective, it normally makes sense to correlate the term of the agreement to the term of the loyalty covenants discussed under the Restrictive Covenants section, below. A long-term agreement can lock in those loyalty protections, and severance may be framed to cover a fixed amount (e.g., one year of salary and bonus) rather than compensation otherwise payable for the remaining term. Renewal provisions are not generally necessary for employers, because they are in the position to discuss extended contract terms at any time, and in that way to identify and manage transition risks.

Executives, however, may prefer a long-term agreement, provided compensation terms are not unduly fixed or divorced from adjustment for peer practices. It is often reasonable to seek substantially equivalent treatment with other executive-level employees.

Automatic renewal provisions tend to provide executives with welcome security, at levels corresponding to the length of the advance notice that is required for nonrenewal. For instance, one year of advance notice provides significant protection in terms of being alert to the need to find a new position.

Three months or less of notice could box the executive into a corner. Because new jobs are tougher to find when unemployed, it may make sense to trade lower severance for a longer notice period.

Salary

Here, from the employer's perspective, locking in salary at a fixed level for several years is often simplest, with cost-of-living escalators being reasonable to include.

It typically benefits an executive to require an annual salary review, with increases being made for cost of living and changes in peer practices.

Bonuses

Maximizing company discretion is generally best, from the employer's perspective, whether or not that involves establishing a target bonus amount or relevant performance factors. High stakes — and litigation risks — can spring from provisions that require the parties to mutually agree on performance-based measures, as well as from requirements that the employer identify and communicate them on a recurring basis, such as before an annual deadline. Open-ended provisions of that kind may sound good at the start but may place the parties at odds when discussions get precise.

For the year of hire, it often makes sense to defuse executive concerns by guaranteeing a minimum bonus amount that is prorated for the time the executive works during the year. It is generally best for employers to condition bonus payments on the executive's employment through the payment date (rather than as of year-end, for instance). Otherwise, the employer faces the risk of having to pay bonuses to those who have already quit.

Contrasted with this position, the uncertainty of a new position may justify the executive’s counsel seeking a minimum guaranteed bonus for the year of hire as well as identifying a target bonus for that year and future ones. If it is not feasible to seek a locked-in formula, the next best thing involves getting an assurance that the target bonus will be paid based on reasonably attainable goals.

That provides leverage if the executive later feels blindsided by unreasonable goals. Particular bonus levels could be sought for project achievements or progress. A year-end (or performance period-end) employment requirement is desirable from an executive's perspective to lock in vesting, rather than conditioning payment on employment through the payment date.

Stock Awards

From the employer's perspective, maximizing discretion is common, both for the nature of what is awarded and how much. When sign-on awards are provided for in an employment agreement, it is important to provide that they will be granted in accordance with the terms of an identified plan, because such a plan is typically the vehicle by which such awards are made.

Restricted stock or units? Stock options? Performance awards? Deferred payouts? The range of alternatives that are important to the executive warrants close attention to assure an executive receives the desired incentive on terms and conditions that are suitable and tax efficient.

For startups, restricted stock can provide a valuable tax benefit through 83(b) elections that result in capital gain treatment from the grant date value forward. Profits interests in limited liability companies or partnerships may also deliver capital gain treatment.

For all awards, it is best for the executive to secure some certainty about the award's terms either by having the employer attach an award form to the employment agreement or by specifying key award terms within the agreement itself. For instance, will a change in control accelerate vesting? What will the vesting terms be? And the expiration date for stock options?[2]

Health Insurance and Other Benefits

For employers, it usually suffices merely to include the executive in all employer benefits plans, subject to their terms and conditions. The commitment may extend to providing benefit levels comparable to those of other similarly situated executives.

Employers should be careful when promising special enhanced benefits for an executive, because most tax-favored plans prohibit such discrimination. Note that there is room for specially tailored benefits under deferred compensation and other nonqualified plans, but it is critical to state that any contractual commitments are deliverable under the terms of any associated benefit plan or policy.

High value can attach to securing access to post-employment employer health plan coverage (e.g., on a retiree basis) if certain age and service conditions are met and, if representing the executive, seek to obtain these benefits in writing. Separately, it may be reasonable for an executive to seek reimbursement for the legal fees incurred to receive personal advice about an employment agreement, especially if the employer is responsible for drafting and offering the agreement.

Perquisites

From a governance perspective, perquisites are an irritant whose toxicity usually outweighs the dollars involved. For employers, it is generally better to draft the agreement to replace specific perquisites through a salary increase that roughly covers their value. Of course, some perquisites may reflect employer goals, such as membership in a particular club, and those are worth retaining.

For the executive, increased salary is often better than receipt of perquisites, in part because salary levels often affect bonus amounts and retirement plan benefits. Plus, the executive is free to do anything with the extra cash.

Public Company Warning

Neither the employer nor the executive wins if items of compensation (such as unjustified tax gross-ups or mega-grants) trigger unfavorable reactions from shareholders or proxy advisory companies, such as Institutional Shareholder Services Inc. and Glass Lewis & Co.[3]

Restrictive Covenants

There is a high value-to-cost benefit from engaging employment counsel who knows applicable state law when drafting restrictive covenants. This is because state laws vary greatly and generally control, and directly impact, the enforceability of noncompetition, nonsolicitation, trade secret and confidentiality provisions.

When representing the employer, preparing overly broad or generic post-employment covenants opens the door for claims that they are unjustifiably restrictive and therefore unenforceable. By contrast, the case for enforcement directly correlates to the precision by which an employer narrows their time, scope and duration to advance legitimate business interests.

Also noteworthy: The federal Defend Trade Secrets Act sets forth whistleblower protections for employees, and they need to be affirmatively addressed in any agreement containing nondisclosure provisions to preserve the employer's ability to recover exemplary damages and attorney fees in a federal action against an employee who divulges employer trade secrets.[4]

Because employers typically take the lead when drafting post-employment covenants, executives often face an intriguing choice. If they argue to narrow the terms of the restrictive covenants, the executive will have broader alternatives upon exiting.

However, by doing so, the executive increases the likelihood that a court will enforce the covenant if a dispute arises. It takes a careful weighing of all implications (including state law alternatives) to navigate the best response to an employer's proposal.

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[1] For additional Lexis Practice Advisor materials on this topic, see Executive Employment Agreement Resource Kit.

[2] For a discussion in Lexis Practice Advisor regarding different kinds of equity awards, see Equity Compensation Types and Tax Treatment.

[3] For a comprehensive list of problematic practices identified by ISS, see ISS, U.S. Compensation Policies: Frequently Asked Questions (Dec. 20, 2018).

[4] 18 U.S.C. § 1833(b)(3).

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