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Drafting Effective Employment and Separation Agreements

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Absence of Employment Agreement — "At Will" Employment

- In a private (non-government) employment relationship, employment is at will unless there is—
  - a written contract or oral agreement of employment that—
  - specifies the duration or a specific period of the employment.
- Significance of employment at will:
  - Either party can terminate the employment relationship at any time for any reason not otherwise illegal (as per federal or state statutes prohibiting discharge or discrimination).
  - The employee has no claim for wrongful discharge.
- Can have an employment agreement and still remain "at will"

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Reasons for Employment Agreements

- Provides clarity as to parties' expectations
- Performance incentives can be well defined
- Outline salary/compensation plans
- Restrictive covenants
- Enforcement/Dispute Resolution (Litigation)

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Key Provisions of Employment Agreements

- Description of employee's duties
- Description of compensation/benefits
- Length of Employment (at-will, term)
- Termination of employment
- Restrictive Covenants
- Nondisclosure/Confidentiality
- Assignment of Inventions

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Term of Agreement / Termination

- At Will
- Term
- Evergreen

> This Agreement shall become effective on the Effective Date and shall have an initial term of one (1) year following the Effective Date (the "Initial Term") unless sooner terminated as provided herein. Thereafter, this Agreement shall be renewed automatically for successive terms of one (1) year each (each a "Renewal Term") unless either party gives the other sixty (60) days' prior written notice of such party's intent not to renew. The Initial Term and each Renewal Term, if any, shall be an "Employment Year."

- Termination Provision
  - With cause
  - Without cause

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Restrictive Covenants

- Types
  - Noncompete
  - Nonsolicitation
  - Nondisclosure*
- No federal law; law differs from state to state
  - Common law
  - Statutory (e.g. Georgia)
- Reasonable restrictions that are no greater than necessary to protect employer's legitimate interest.

Restrictive Covenants: Essential Elements

- Consideration
  - Offer of employment
  - Change in job duties
  - Monetary compensation

- Define “business” and “services” that would constitute competition

- Geographic restrictions / customer restrictions that are no greater than necessary to protect Company’s legitimate interest.

Reasonable Scope of Restrictive Covenants

- Geographic restrictions
  - Customer location
  - Employee assigned area
  - Employee location
  - Employer location
- Time
- Customer restrictions
  - Present
  - Prospective
  - Those employee had contact with
- Similar services/related work

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Sample Noncompete

(a) During the period of my employment with the Company and for a period of twelve (12) months after the termination of my employment with the Company, I agree that I will not:

(1) directly or through another person engage in a business similar to and competitive with that of the Company within:

(a) the states of NC, SC, GA and FL; and/or

(b) North Carolina; and/or

(c) 100 miles of the Company's corporate headquarters.

(2) within the geographic area acknowledged in section (a)(1) above, engage, directly or indirectly, by myself or in connection with any other person(s) or company(ies) in the developing, servicing, retailing or marketing, (including but not limited to the establishment of service prices), of any service which will compete with any service which I am aware the Company is then servicing, retailing, marketing or developing, or is in the process of, servicing, retailing, marketing or developing;

(3) within the geographic area acknowledged in section (a)(1) above, engage, directly or indirectly, by myself or in connection with any other person(s) or company(ies) in the developing, servicing, retailing or marketing, (including but not limited to the establishment of service prices), of any service which will compete with any service which I am aware the Company is then servicing, retailing, marketing or developing, or is in the process of, servicing, retailing, marketing or developing.

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Sample Noncompete

Employee recognizes and understands that through Employee's association with the Company, Employee shall acquire a considerable amount of knowledge and goodwill with respect to the business of the Company, which knowledge and goodwill are extremely valuable to the Company and which would be extremely detrimental to the Company if used by Employee to compete with the Company. Employee therefore agrees that because of the nature of the business of the Company, it is necessary to afford fair protection to the Company from such unfair competition. Consequently, in further consideration of the compensation Employee is to be paid hereunder, during the term of this Agreement and for a period of twenty-four (24) months immediately following the termination of this Agreement for any reason, whether voluntary or involuntary, with or without cause, Employee agrees that Employee will not, directly or indirectly, provide Restricted Services for any person or entity engaged in the Business in the Restricted Territory. "*Restricted Services*" means scientific research and development and business development. The "*Business*" is defined as the development and commercialization of polymers.

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Nonsolicitation

- Nonsolicitation of Clients
  - Clients that employee had contact with
  - Current clients
  - Prospective clients

  solicit, directly or indirectly, for myself or on behalf of any other person(s) or company(ies) any product or service similar to and competitive with any product or service of the Company's to any client of the Company (i) to whom I solicited or sold, directly or indirectly, the Company's products or services during the twelve (12) months preceding the date of my termination; (ii) who I am aware or reasonably should have been aware purchased services from the Company at any time in the twelve (12) months preceding the date of my termination; or (iii) whom the Company is actively soliciting within twelve (12) months preceding my termination;

- Nonsolicitation of Employees

  While working for the Company and for twelve (12) months following the termination of my employment with the Company, I will not attempt to induce or influence, either directly or indirectly, any employee of the Company to leave the Company's employ.

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Modifications by Courts

- Reformation
  - Court will reform to make the covenants reasonable
- Blue Pencil (NC)
  - Court can strike out unreasonable provisions, but cannot reform or modify language
- All or nothing
  - If Court finds unreasonable, it is not enforceable.

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Restrictive Covenants

- Include Employee acknowledgments
  - Restrictions are reasonable and necessary to protect Company
  - Employer will be irreparably harmed and that monetary damages are insufficient remedy
  - Employee consents to enforcement of the restrictive covenant through injunctive relief.
  - Subject to any other noncompete, nonsolicitation or confidentiality agreement?

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Nondisclosure/Confidentiality

- Protect trade secrets, client lists, proprietary information, process
- No additional consideration needed in NC
- Define “Confidential Information”
- Disclosure only if through legal process (i.e. subpoena or court order)
- Notice to Company prior to any disclosure

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Sample Nondisclosure/Confidentiality

(a) I acknowledge that all Confidential Information is the property of the Company and shall remain so. I agree to keep in strictest confidence and protect from disclosure all Confidential Information which I receive or have access to during and subsequent to my employment. Unless I have the prior written consent from the CEO, I will not at any time during or after termination of my employment with the Company, directly or indirectly publish, disclose, describe or communicate, or authorize anyone else to publish, disclose, describe or communicate to any person, firm, business entity or corporation, or use to the Company's detriment or for purposes other than the corporate purposes of the Company, any Confidential Information, except as generally allowed in the conduct of the Company's business or as authorized, in writing, by the CEO of the Company.

(b) Both during and after the term of this Agreement, I agree to preserve and protect the confidentiality of the Confidential Information and all physical forms thereof, whether disclosed to me before this Agreement is signed or afterward. In addition, I shall not (i) disclose or disseminate the Confidential Information to any third party, including employees of the Company; (ii) remove Confidential Information from Employer's premises; or (iii) use Confidential Information for my own benefit or any third party.

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Assignment of Inventions

- Protect intellectual property (patents, trademarks, copyrights, patents, trade secrets)
- Use when employees are creating new and patentable material
- Employee agrees that anything created on behalf of the Company (i.e. paid for) will be owned by the Company
- Must be related to Company's business

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Separation Agreement

Is a Separation Agreement appropriate?

- Employer policy
- Employer practice
- Employee relations philosophy
- Potential exposure
- Likelihood of litigation
- Reason for separation

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Pros & Cons

Pros

- Usually cheaper than litigation
- Effective tool to prevent litigation

Cons

- May generate claims
- May send wrong message to others
- Selective offers — discrimination

Separation Agreements: Essential Elements

- Additional consideration
  - Severance payment
  - Vacation payout
  - COBRA payments

- Release of claims
  - Knowing and voluntary
  - Unreleasable claims (recent NC Wage and Hour opinion)
  - Timing
  - Federal

    Older Workers Benefits Protection Act (“OWBPA”):

    Consideration Period: 21/45 days

    Revocation Period: 7 days

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Separation Agreements: Essential Elements

- Covenant not to sue
  - EEOC charges permitted; no monetary award available
  - Judicial determination of validity of ADEA release permitted
- Indemnification and payback provisions
  - For breach of agreement
- No admission of unlawful or wrongful conduct by Company

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Additional Issues

- Cooperation
  - Winding up of employee's work
  - Transition of work
  - Pending or ongoing litigation
- References
- Outplacement/unemployment benefits
- Return of company property
- Restrictive covenants (if not included in employment agreement)

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Additional Issues

- Non-disparagement
- Confidentiality
- Reaffirmation of prior agreements
- Attorneys' fees
- Severance
  - Amount
  - Schedule of payments
  - Section 409A issue

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Additional Issues

- Choice of law / venue
- Severability
- No changes unless in writing
- Conspicuous “Knowing and Voluntary Agreement” language

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Knowing and Voluntary Agreement

BY YOUR SIGNATURE BELOW, YOU ACKNOWLEDGE AND AGREE THAT (1) YOU HAVE CAREFULLY READ AND CONSIDERED THIS AGREEMENT; (2) YOU HAVE BEEN GIVEN SUFFICIENT TIME TO CONSIDER WHETHER TO SIGN THIS AGREEMENT; (3) YOU RECOGNIZE AND UNDERSTAND THAT THIS AGREEMENT CONTAINS A FULL AND FINAL RELEASE BY YOU OF ALL CLAIMS OF EVERY KIND AGAINST THE COMPANY ARISING UP TO THE TIME YOU SIGN THIS AGREEMENT, WHETHER YOU CURRENTLY KNOW OR SUSPECT THOSE CLAIMS TO EXIST; AND (4) YOU KNOWINGLY AND VOLUNTARILY CONSENT TO THE TERMS OF THIS AGREEMENT WITH FULL UNDERSTANDING OF THEIR MEANING.

Section 409A

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Introduction – Topics to Cover

- Brief overview of Section 409A and Section 409A correction programs
- Key exceptions that may apply to exempt payments under an employment or severance agreement from Section 409A
- Top 10 Section 409A mistakes that are found in employment and severance agreements and how to fix them

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Brief Overview of Section 409A

- Section 409A became effective 1/1/2005.
- *Operational* compliance was required immediately, although certain transition relief continued through 12/31/2008.
- As of 1/1/2009, all plans and arrangements subject to Section 409A had to be in *documentary* compliance with Section 409A.

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Brief Overview of Section 409A

- Penalties for failure to comply with Section 409A are harsh.
- Noncompliant compensation is included in the employee's income during the first year in which it is both:
  - noncompliant with the requirements of Section 409A, and
  - not subject to a substantial risk of forfeiture.
- Both a 20% penalty tax and penalty interest also apply to the noncompliant compensation; these amounts are payable by the employee.
- The employer may face penalties relating to reporting and withholding on the affected compensation.

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Brief Overview of Section 409A Correction Programs

- Two correction programs are available.
  - Notice 2008-113 permits correction of certain *operational* violations.
  - Notice 2010-6 permits correction of certain *documentary* violations.
  - Notice 2010-80 modified certain provisions of these correction programs.
- Relief is limited and may involve uncomfortable disclosures to the IRS and the affected employee as well as the payment of penalties by the affected employee.
- Correction is also possible under proposed income inclusion regulations.

What is Section 409A Deferred Compensation?

- In general: Section 409A applies to any current legally binding right to receive compensation in a future year. This is a very broad standard and covers, in part:
  - Traditional deferred compensation plans
  - Bonus arrangements
  - Employment agreements with post-employment benefits
  - Standing or intermittent severance plans
  - Ad hoc severance arrangements
- For employment agreements and severance pay, several key exceptions are available.
- If an exception is not available, the arrangement must meet the requirements of Section 409A.

Key Exceptions for Severance Pay

- "Short-Term Deferral" Exception
  - Available for compensation that is paid not later than the later of (i) 2½ months after the end of the employer's fiscal year, or (ii) March 15th of the calendar year, following the calendar year in which the right to the compensation becomes substantially vested.
  - Severance pay triggered by an involuntary separation is not "vested" until the separation occurs.
  - However, severance pay triggered by a resignation may or may not be considered "vested" when the arrangement is established.

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Key Exceptions for Severance Pay

- "Two-Times Compensation" Exception
  - Only available for involuntary separations and voluntary separations during a "window" program.
  - The aggregate amount of severance pay and benefits must not exceed two times the employee's annual compensation in the year prior to the year of separation.
    - However, compensation is limited to the 401(a)(17) limit for the year of separation.
    - The 2016 limit is $265,000, meaning the maximum possible exclusion in 2016 is $530,000.
  - All payments must be made not later than the end of the second tax year after the tax year of the separation.

Mistake #1 - No Definition, Ambiguous Definition or Bad Definition of Key Term

- Section 409A uses precise definitions for certain terms.
- Sometimes documents don't define these terms or use ambiguous definitions.
  - For example, a severance agreement might provide for payment upon "termination of employment" but not define the term.
  - If the agreement has a Section 409A "savings clause", the term is deemed to have the proper Section 409A definition.
    - "It is intended that the provisions of this Agreement comply with Section 409A, and all provisions of this Agreement shall be construed and interpreted in a manner consistent with the requirements for avoiding taxes or penalties under Section 409A."
  - As a result, if the agreement has a savings clause, there will be no Section 409A violation so long as the plan is operated pursuant to the Section 409A proper definition.

Mistake #1 - No Definition, Ambiguous Definition or Bad Definition of Key Term

- If the agreement does not have a savings clause, it may be possible to correct without penalty, at any time prior to the year in which the amount becomes vested, by amending the agreement to:
  - add a savings clause, or
  - add a proper definition.
- If the agreement does not have a savings clause and an amount has been paid (or is vested and has not been paid) based on a noncompliant definition:
  - Correct as an operational violation (e.g., payment made too early or too late), and
  - Amend before end of employee's taxable year in which correction is made to either add a savings clause or add a proper definition (definition cannot include previously excluded payment events or exclude previously included payment events).

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Mistake #1 - No Definition, Ambiguous Definition or Bad Definition of Key Term

- Sometimes the documents contain impermissible definitions of key terms. Corrections are available for three terms: separation from service, change in control and disability.
  - Separation from Service ("SFS"):
    - May be able to correct without penalty, at any time prior to the year in which the amount becomes vested, by amending to fix the definition.
    - Once vested, correct by amending to fix the definition before an event occurs that would not be a SFS under Section 409A but is a SFS under the document, or before an event occurs that would be a SFS under Section 409A but is not a SFS under the document (the amended definition cannot include previously excluded events or exclude previously included events).
    - If a SFS under the pre-amendment definition occurs within one year following correction, 50% of the amount to which the pre-amendment definition applied must be included in income under Section 409A in the year in which the event occurs.
    - Tax reporting requirements apply to the employer and the employee.

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Mistake #2 – Bad "Good Reason" Definition

- Some arrangements allow the employee to receive severance pay if the employee resigns for "good reason."
- To qualify as an involuntary termination, definition of good reason must require employer to take action resulting in a material, negative change to employee in the service relationship, such as duties to be performed, conditions under which such duties are to be performed, or compensation to be received for performing such services.

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Mistake #2 – Bad "Good Reason" Definition

- Final regulations contain a safe harbor
  - Material diminution in base compensation
  - Material diminution in authority, duties, or responsibilities of employee or of employee's supervisor
  - Material change in location at which service provider works
  - Material breach of employment agreement
- Must give employer notice shortly following occurrence of "good reason" event;
- Employer must have at least 30 days to cure; and
- If employer does not cure, employee must separate within specified period following occurrence of good reason event (specified period cannot be longer than 2 years).

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Mistake #2 – Bad "Good Reason" Definition

- If good reason is triggered by *any* reduction in compensation, it doesn't meet IRS safe harbor.
- If good reason definition doesn't meet safe harbor:
  - May take position that it still constitutes an involuntary termination and leave as is or revise to more closely comply with safe harbor;
  - If not vested, may amend to comply with the safe harbor; or
  - If vested and too late to "fix", then must comply with Section 409A, and may need to amend other provisions to ensure compliance.
- If a bad "good reason" definition cannot be fixed, then the short-term deferral and two-times compensation exemptions are usually not available for any portion of the severance.

Mistake #3 – Payment Period Longer than 90 Days

- The payment period can a single taxable year or a period that begins and ends in the same taxable year.
- It can also be a period of up to 90 days that could span two taxable years, so long as the employee cannot pick the year of payment).
  - May be able to correct without penalty, at any time prior to the year in which the amount becomes vested, by amending to shorten the payment period.
  - Once vested, amend to shorten the payment period. Tax reporting requirements apply to the employer and the employee.
  - If amendment is made after payment event occurs, and payment in fact was made within 90 days after payment event and employee in fact was not allowed to control year of payment, then employee must include 50% of payment in income and pay 20% penalty tax. Tax reporting requirements apply to the employer and the employee.

Mistake #4 – Impermissible Alternative Payment Forms or Schedules

- "Severance shall be paid as salary continuation payments during the 24-month severance period. If, however, the Executive terminates employment due to disability, the severance shall be paid in a lump sum."
- Violates Section 409A because the same payment event (separation from service) has two different payment forms (installments and lump sum).

Mistake #4 – Impermissible Alternative Payment Forms or Schedules

- If the severance is not vested (and won't vest before the end of the year), fix by amending agreement to only have one of the payment schedules.
- If vested, can still correct under Notice 2010-6 before the payment event (separation from service) occurs.
  - Must remove lump sum and keep the longer installment payment method.
  - If payment trigger occurs within one year of amendment date, must include 50% of payment in income under 409A and pay 20% tax. Tax reporting requirements apply to the employer and the employee.

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Mistake #5 – Paying Too Early

- An employment agreement may provide for severance pay to be paid in installments over a period of time – e.g., 18 or 24 months. Sometimes the employer wants to accelerate payment into a lump sum shortly after employment termination.
- If the arrangement is not exempt from Section 409A, this acceleration is impermissible.
- Correction opportunities depend on how quickly the problem is discovered.

Mistake #5 – Paying Too Early

- If corrected in the same year as the accelerated payment:
  - Employee must repay full amount by end of year.
  - If "insider" and amount exceeds 402(g) limit, employee must pay interest to employer.
  - Employer must attach statement to its tax return regarding the violation.
  - Employee does not include payment in income and has no penalties.
- If corrected in year immediately following year of accelerated payment:
  - This correction method is available only if employee is not an "insider."
  - Employee must repay full amount, plus interest, by end of year.
  - Employee must include amount in income for year of payment but no penalties apply.
  - Employer and employee must attach statements to their tax returns regarding violation.

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Mistake #5 – Paying Too Early

- If corrected by second year following year of acceleration and does not exceed the 402(g) limit for year of acceleration ($18,000 in 2016):
  - Employee does not repay amount.
  - Employer must report as taxable under 409A for year of payment (amended W-2).
  - Employee must include in income for year of payment, and 20% penalty tax applies.
  - Both employer and employee must attach statements to their tax returns.
- If corrected by second year following year of acceleration and more than 402(g) limit for year of acceleration ($18,000 in 2016):
  - Employee must repay amount. If insider, employee must also pay interest to employer.
  - Employer must report as taxable under 409A for year of payment (amended W-2).
  - Employee must include in income for year of payment, and 20% penalty tax applies.
  - Both employer and employee must attach statements to their tax returns.

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Mistake #6 – Paying Too Late

- Employment agreement provides for payments in installments beginning with first payroll date after termination of employment, but some of the payments are delayed or missed and not made until a later calendar year.
- Corrections are very similar to corrections for paying too early, except it is not a violation if pay late in same year, so no correction necessary.
- If corrected in the year following year of erroneous deferral (and not an insider),
  - Employer must pay the missed payments without earnings.
  - Employee must include amount in income for year of payment but no penalties apply.
  - Both employer and employee must attach statements to their tax returns.

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Mistake #6 – Paying Too Late

- If corrected by second year following year payment was due and < 402(g) limit:
  - Employer must report as taxable under 409A for year of payment.
  - Employee must include in income for year of payment, and 20% penalty tax applies.
  - Both employer and employee must attach statements to their tax returns.
- If corrected by second year following year payment was due and > 402(g) limit:
  - Employer must report as taxable under 409A for year in which the payment was due (amended W-2).
  - Employee must include in income for year in which payment was due, and 20% penalty tax applies (amended tax return).
  - Both employer and employee must attach statements to their tax returns.

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Mistake #7 – Improper Release Requirement

- When an employer provides severance pay to an employee following employment termination, usually the employer will require the employee to sign a general release of claims against the employer as a condition for receiving the severance pay. For example:
  - "In the event of an involuntary termination of employment, and after the employee signs a release of claims against the Company and such release becomes effective, the Company shall pay the employee 24 months of base salary in 24 equal monthly installments."
  - "Any severance pay due to the employee under this Agreement is conditioned upon the employee's execution of a general release of claims in the form attached hereto as Exhibit A."

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Mistake #7 – Improper Release Requirement

- Section 409A permits payment to be triggered only by six events. The six events do not include signing a release of claims.
- Many employment agreements contain this violation. To correct:
  - If plan has a designated payment period following payment trigger, either:
    - Amend to pay on last day of designated period, or
    - Add requirement that if designated payment period straddles two taxable years, pay in second taxable year
  - If plan does not have a designated payment period following payment trigger, either
    - Amend to pay on 60th or 90th day following payment trigger, or
    - Add a designated payment period not longer than 90 days and specify that if designated payment period straddles two taxable years, pay in second taxable year.
  - Tax reporting requirements apply to employer and employee.

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Mistake #8 – Continuation of Benefits

- "The Employee shall be entitled to continue to participate in all Company benefit plans during the severance period."
- Types of benefits at issue: life and disability insurance, qualified retirement plans, medical and dental plans, other benefits (e.g., car allowance, annual bonus plans).
- If agreement has savings clause or the benefits are not vested, amend as necessary to clarify and be specific as to what will be paid when.
  - For example, will actual premiums be reimbursed or will an amount equal to the premium at termination date be paid in a lump sum or monthly.
  - For continued health insurance, avoid 105(h) issues by paying the employee the COBRA premium (with or without tax gross up) and requiring employee to pay COBRA.

Mistake #9 - Improper Expense Reimbursement Provisions

- An exception is available for reimbursements of specified categories of expenses under a separation pay arrangement.
  - Specified categories: reimbursements otherwise excludable from income, deductible business expenses, reasonable outplacement expenses, reasonable moving expenses.
  - Expenses must be incurred by end of second tax year after tax year of separation.
  - Reimbursements must be made by end of third tax year after tax year of separation.
- Another exception is available for taxable reimbursements of medical expenses limited to the period of COBRA coverage otherwise available to the employee.
- Another "catch-all" exception is available for payments that in the aggregate do not exceed the 402(g) limit for the year of separation ($18,000 for 2016). No time limits apply under this exception.

Mistake #9 - Improper Expense Reimbursement Provisions

- If reimbursements are not exempt, there is a special rule for how the reimbursement arrangement may comply with Section 409A.
  - Determinable, nondiscretionary definition of the expenses eligible for reimbursement .
  - Reimbursement available only for expenses incurred during an objectively and specifically prescribed period (including lifetime of employee).
  - Amount of expenses eligible for reimbursement during one tax year may not affect the expenses eligible for reimbursement in another tax year.
    - "Employer will reimburse employee for up to $50,000 in country club dues for up to 5 years following his termination of employment."
  - Reimbursement must be made by the last day of the tax year following the tax year in which the expense is incurred.
  - Right to reimbursement must not be subject to liquidation or exchange for another benefit.

Mistake #9 - Improper Expense Reimbursement Provisions

- Correction possible before event occurs that results in reimbursement right.
  - Generally, correct by amending to comply with desired exemption. However, if provision violates the requirement that the amount eligible for reimbursement in one year cannot affect amount eligible for reimbursement in another year, then amendment must allocate amount eligible for reimbursement pro rata over number of years during which employee is eligible for reimbursement.
    - If lifetime entitlement, then prorate based on employee's life expectancy under reasonable actuarial assumptions.
    - If eligible for reimbursement during period ending with an event, prorate based on reasonable assumptions and over no fewer than 3 years.
  - If event occurs within 1 year of correction, include 50% in income under 409A and pay 20% penalty tax.
  - Tax reporting requirements apply to employer and employee.

Mistake #10 – Failure to Include "Separate Payment" Language

- Section 409A will treat a stream of installment payments (e.g., salary continuation payments) as one payment unless the plan or agreement specifically provides that each installment payment is a separate payment for Section 409A purposes.
- By designating each installment as a separate payment, the short-term deferral exception can be combined with the two-times compensation exception.
- In drafting new employment and severance agreements, should usually include this separate payment language.
- If agreement doesn't have separate payment language, may need to review other slides to fix the agreement to comply with Section 409A rules.

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QUESTIONS?

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