The Metropolitan
Corporate Counsel®

www.metrocorpcounsel.com

Volume 14, No. 7 July 2006

How Executive Employment Agreements Work In Practice

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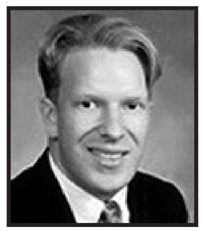
It is no secret that, regardless of its other assets, no company will succeed for long without the leadership of effective senior management. As a result, structuring employment agreements to attract senior management and properly incentivize them should be a priority for every company seeking to succeed in the marketplace. This article briefly presents a "user friendly" overview of how some typical provisions of employment agreements work in practice.

Introduction

Although employment agreements are typically entered into at the beginning of the employment relationship, when optimism and hope are at their pinnacle, in practice one of the most important functions of the employment agreement is to determine the rights bestowed and restrictions imposed upon the executive when his or her employment is terminated. As a result, parties negotiating employment agreements need to be pragmatic and focus their attention on the ways in which the employment relationship can come undone and determine how the respective rights and obligations of the company and the executive will flow from those outcomes. With this practical focus in mind, we now discuss some typical executive employment scenarios and the ways in which employment agreement terms are implicated.



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• *The "Win-Win" Scenario*. The executive performs as expected, satisfying the goals established by the company for him or her and the company provides the executive with both fair compensation and meaningful opportunities for advancement. The company does so well that it is eventually acquired by a competitor and, as part of the post-acquisition consolidation, a negotiated termination of the executive's employment occurs.

• *The "Underperforming Executive" Scenario*. Although the executive believes that he or she is performing at or above expectations, the company is dissatisfied with that performance and takes actions in response to the executive's deficiencies, including moving the executive into a new position within the company more consistent with the company's view of the executive's abilities. As part of this process, the company double-checks some of the executive's references and learns that the executive's previous position was actually a VP of Finance-level position, rather than the Chief Financial Officer-level position intimated by the executive during the interviewing process. The executive is displeased with his or her new position, in part because it entails reporting to someone who used to be the executive's subordinate, and starts interviewing for a new position and trying to persuade other company employees to leave the company and join the executive's new venture. Word of these overtures gets back to the executive's superiors and the company terminates the executive's employment.

• *The "Changed Circumstances" Scenario*. The executive is hired based upon expectations concerning his or her role in the company and opportunities for advancement formed in response to representations made by company representatives. However, the strategic direction of the company subsequently changes, which has the effect of diminishing the executive's role in the company's future. The company is unsure of what to do with the executive and takes actions to make the executive's work experience less pleasant such as excluding the executive from high-profile projects and moving the executive to another company office location, hoping that the executive will voluntarily decide to move on and not force the company to terminate him or her. The executive ultimately obtains a new position and resigns from the company, with plenty of bad feelings toward the company.

Termination For "Cause" Or For "Good Reason"

Some of the most important provisions in the employment agreement – severance, vesting of equity incentives and the length of non-compete and non-solicit covenants – often hinge upon the concepts of termination of the executive's employment by the company for "Cause" or by the executive for "Good Reason." Because of their importance, the definitions of these terms are often heavily negotiated and can vary significantly. There are, however, some "market" provisions for these terms, with the burden of proof usually on the company to show that a company-initiated employment termination was for "Cause" and on the executive to show that an executive-initiated employment termination was for "Good Reason."

"Cause" is typically defined to include some or all of the following actions:

• willful failure or refusal by the executive to implement or follow policies or directions of the board of directors or another direct report that the executive failed to cure after notice from the company;

• commission by the executive of an act of moral turpitude or act bringing disgrace or disrepute to the company, or commission of/conviction for any felony or any misdemeanor involving theft, fraud or other dishon-

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est action or event that results in harm to the company;

• material violation of the employment agreement (especially confidentiality, non-solicit and non-compete provisions), sometimes defined to require gross negligence or willfulness; and

• material misrepresentation or material and willful non-disclosure by the executive to the board of directors or other direct report in connection with performance of the executive's duties.

"Good Reason" is typically defined to include some or all of the following actions:

• adverse change in title or material diminution in the executive's duties and responsibilities (i.e., a demotion);

• company-required relocation of the executive from the location at which the executive was hired to work to another location more than a specified number of miles away from the initial location (typically far enough away to make commuting to the new location from the executive's home not feasible); and

• failure by the company to pay any required amount (i.e., base salary, bonus or expense reimbursement) under the employment agreement or other breach of the employment agreement.

In the "Win-Win" scenario, the parties will typically agree that, for purposes of the employment agreement, the termination will be considered to have been by the company "without Cause" because it entitles the executive to the most advantageous severance benefits, consistent with the successful outcome achieved in part through the executive's efforts.

In the "Underperforming Executive" scenario, the company would have likely consulted with counsel before moving the executive to the new position, who would have advised the company that the executive's generally subpar performance would not, by itself, rise to the level of "Cause" for purposes of the employment agreement. Counsel would also have advised that the executive's verbal misrepresentation concerning the nature of his or her prior position would be difficult to prove and, in any event, might not be "in connection with performance of the executive's duties" for purposes of the "Cause" definition (a company policy, strictly enforced, calling for the termination of employees found to have materially misrepresented their credentials during the application process generally enables the company to terminate the employee but not to invoke a "for Cause" termination). Counsel would have warned the company that the position change could be a "material diminution of duties" or an "adverse change in title", entitling the executive to resign for "Good Reason". The executive's solicitation of company employees for his or her new venture would most likely constitute a material violation of the non-solicit covenant of the employment agreement, entitling the company to terminate the executive for "Cause."

In the "Changed Circumstances" scenario, because the company didn't take any "official" actions concerning the executive's position or title, it is possible (although not advisable) that counsel wouldn't have been consulted until the company receives a letter from the executive claiming "Good Reason" for the resignation and demanding severance and other termination benefits. The executive would likely argue that the change in company office location was a "company-mandated relocation" and the reduction in responsibilities resulting from the change in the company's strategic direction constituted a "material diminution of duties". The company could respond that the new office location wasn't far enough away to satisfy the "relocation" standard and the change in duties was not a "material" diminution.

Severance And Other Benefits Upon Termination

As noted above, whether a termination meets the requirements for "Cause" or "Good Reason" is important because it typically determines whether or not the executive will be entitled to receive severance and sometimes has other effects including acceleration of vesting of the executive's equity incentives and reduction in length or elimination in the executive's non-compete and non-solicit covenants. Some employment agreements provide the same benefits to the executive for a termination by the company without "Cause" as for a resignation by the executive for "Good Reason", on the reasoning that the actions by the company constituting "Good Reason" are equivalent to a constructive dismissal. Other employment agreements entitle the executive to receive greater benefits for a termination without "Cause" than for a "Good Reason" termination because a termination without "Cause" is usually made by the company without the executive's knowledge or advance notice, leaving him or her in a worse position than a voluntary resignation, even if that resignation was instigated by the company's actions.

Typically, the principal benefit accruing to the executive upon a termination without "Cause" or "Good Reason" is severance, which can be payable in a lump sum upon termination or in payments over time after termination. The advantage to the latter approach, from the company's perspective, is that the severance payments can secure the executive's performance of his or her non-compete and non-solicit obligations. Severance payments are usually made contingent upon the executive signing a release of claims against the company and return by the executive of company property such as laptop computers and cell phones. Severance amounts in employment agreements are usually expressed as a percentage of the executive's annual base salary amount. Sometimes, in addition to the base salary component, severance will include a *pro rata* portion of a "target" bonus amount that would have been paid in the year of termination or an amount determined by averaging past bonuses. Typically, termination by the company for "Cause" or by the executive without "Good Reason" results in no severance being paid to the executive.

Employment agreements sometimes provide that termination without "Cause" or for "Good Reason" will result in "accelerated" vesting of equity incentives such as stock options, restricted stock and SARs (i.e., the full benefit can be immediately realized by the executive upon termination, as if the executive had worked for the specified vesting period). Sometimes employment agreements provide that termination without "Cause" or for "Good Reason" requires the company to forgive all or part of any loans to the executive used to finance purchase of restricted stock or, in the case of stock option grants, requires the company to extend the time period after termination that the executive is entitled to exercise his or her stock options. Termination by the company for "Cause" typically results in the executive forfeiting all rights under equity incentives, while termination by the executive without "Good Reason" is usually treated as a general termination of employment for purposes of equity incentives.

Although non-compete and non-solicit covenants in employment agreements are generally triggered upon any termination of employment, executives will sometimes try to negotiate a reduction in length or elimination of the non-compete and (to a lesser extent) non-solicit covenants if the executive is terminated without "Cause" or terminates for "Good Reason." The argument in favor of doing so is that, as the company made the choice to terminate the executive without "Cause" or take the actions constituting "Good Reason", it has implicitly made the determination that the executive is of little competitive threat. The response to this argument is that, because such terminations will usually entitle the executive to receive severance and other benefits, that compensation should be sufficient consideration for the executive being forced to "sit on the beach", not working in his or her chosen field, for the period of the non-compete or non-solicit clause.

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Hopefully, this overview was helpful in explaining the practical application of some typical employment agreement provisions.