

## Employment Contracts: Why, Why, When, and How

### When to offer an Employment Contract and What to Include:

#### Question

My company has never given an employment contract to any employee, but now we are planning to hire someone who wants a contract. What are the advantages and disadvantages of employment contracts and what problems do they protect against?

#### Answer

According to most lawyers, employment contracts primarily benefit the employee and may do nothing for the company. The best advice we know of is this: give an employment contract if you have to in order to get someone you want to hire or hold on to someone you want to keep, but otherwise stay away from them *unless* your lawyer strongly recommends a specific contract for *your* protection (e.g., a valuable employee who could adversely impact sales if hired by a competitor).

Now to our advisory on the subject of employment contracts.

Owners of smaller and mid-sized companies are particularly vulnerable to the loss, departure, or, termination of a key person. That is especially true for sales and marketing executives, who can represent a good percent of the company's business and who have inside access to the company's products, customers, industry niche, and business plans.

*Consider these actual events:*

**#1.** One top sales executive, hired two years ago, increased company sales by more than 30% annually. He alone was responsible for about 40% of the company's total sales. At the end of the two years, he demanded a big salary increase and an option to buy 10% of the company at a bargain price. When the owner refused, this executive went into business for himself and is now one of the company's major competitors. *Problem:* There was no employment contract nor noncompete agreement with his original employer to prevent him from doing so.

**#2.** A second executive sued her employer for a full year's salary after she quit because she was asked to relocate. The relocation issue had been discussed with company management in an informal meeting that had taken place several years earlier. At that time, the executive indicated that because of family responsibilities she could never relocate. Her written memo of that earlier meeting's discussion led the court to rule in her favor. The employer was directed to pay the executive \$90,000 in lost wages plus her legal expenses. *Problem:* There was no written contract specifying the terms of her employment nor the company's rights and flexibility in changing her job assignment.

**#3.** Another executive decided to start his own company within 30 miles of his previous employer's offices. He is now in direct competition with the company, using the knowledge he gained when he had access to the company's customer list and marketing plan. *Problem:*

Again, there was no employment contract nor noncompete agreement to keep him from doing so.

**#4.** An executive, who owned 20% of the business he worked for, was fired after the 80% owner became dissatisfied with his performance. The executive sued and the court ruled in his favor, ordering the company to pay him six months' salary and to buy his 20% ownership position. The company was given six months to determine the stock's value and negotiate payment terms satisfactory to both the executive and the court. *Problem:* There was no written contract indicating legitimate causes for dismissal, the procedure for termination, the process for buying back the stock, nor the formula for setting the buy-back price.

In all of these cases, there were no formal legal contracts nor memos of understanding specifying the terms of employment, protecting privileged "insider" company information, or preventing departed or dissatisfied executives from using their knowledge of a former employer in competing against that employer.

### **Providing Protection**

One benefit of an employment contract is it can work to prevent misunderstandings between executives and their employers as to each party's rights and responsibilities. It also can work to protect the company against potential losses or lawsuits in the event of an executive's early walkout or his or her nonperformance of assigned duties. A formal employment contract or memorandum of understanding should be written to protect against any and all risks to which your company is particularly susceptible. Following are provisions you should consider including.

#### **Executive inflexibility**

Business needs and circumstances change and it may become necessary to switch an executive from one assignment to another. But he or she just might refuse, claiming that is not the job for which he was hired.

*Contract provision:* Describe the executive's responsibilities in detail, but in terms broad enough to allow you flexibility in assigning future projects and other responsibilities as they emerge and in relocating executives to departments or facilities where they are needed.

#### **Malfesance.**

Protect against a key person performing at less-than-expected standards.

*Contract provision:* The employment contract should be quite clear in establishing the grounds for early or immediate termination and in defining severance pay and termination notice periods, e.g., two weeks' or one month's notice.

#### **Misappropriation of confidential information**

Most executives have access to trade secrets, customer lists, and other confidential data, such as the company's long-range marketing plans. Careless or deliberate leaking of this information

to competitors or using it for personal gain can undermine a company's sales and market position.

*Contract provision:* Include a clause in the contract that obligates the employee to refrain from using or disclosing *any* confidential information obtained while he is employed by the company and after he has left. *Note:* Regarding inventions and patents, stipulate that the employee should give prompt disclosure of all discoveries and assignment to the employer of all rights to any inventions and patents developed while employed by the company.

**Always build in an option to sever the relationship after trail period of three to six months.**

### **Post-employment competition**

No business wants more competition, particularly from a former employee who can use the company's training and experience to sell competitive products, make inroads into your marketplace, or solicit your customers.

*Contract provision:* Insert a *covenant not to compete*. Do not make the clause so restrictive that a court could interpret it as eliminating the executive's means or livelihood. The covenant should not prohibit the executive from working in job functions, geographical territories, or product areas that are not in direct competition with you. In addition, the specific period during which the executive is prohibited from competing with a former employer should not be so long as to be unreasonable, e.g., more than five years. The geographical area covered also must be reasonable, e.g., not the entire United States if your company's sales are principally in the New England area.

### **Automatic termination**

You want to be able to terminate employment *immediately* in the case of events or actions which can seriously injure the company or its reputation.

*Contract provision:* Indicate that the following events are grounds for *automatic* termination: (a) a material breach of the employment contract, (b) dishonesty or conviction by a court for fraud, embezzlement, or felony, (c) engagement and ownership in any business in competition with the company, and (d) disclosure of the company's trade secrets, inventions, and other proprietary information, such as a customer list or marketing plan, to persons outside the company.

## **Get Terms in Writing**

An executive's compensation and benefits can be easily misunderstood in the verbal give-and-take of an employment interview. And any wrong assumptions can cause future dissension, dissatisfaction, and lawsuits.

*What to do:* Spell out all the facts in an employment letter or formal contract: compensation and how bonuses if any, are computed; retirement plan contributions and stock options; vacation

pay; illness, medical, and disability coverage; expense reimbursement and documentation requirements; and severance pay if employment is terminated. If the executive is expected to travel extensively or work weekends, also include those facts in the letter or contract.

*Avoid more legal problems:* Stipulate that the final terms of the signed employment agreement supersede all previous communications, negotiations, representations, and agreements. Specify that your company's domicile (state residence) will be the jurisdiction to settle legal disputes. Indicate that any amendment, additions, or modifications to the agreement must be in writing and signed by each party.

*Your right to terminate:* Don't lock yourself into a long-term contract early on. Build in an option to sever the relationship after a trial period of three to six months. You also should specify that any termination during the trial period is *solely* at your option and *with* or *without* cause. After that period, the employee's rights to notice and severance kick in.

### **Cautions on Firing**

Whether you have an employment contract or not, all employees and executives have legal rights; so protect yourself by doing the following:

- Keep a detailed record of the executive's actions and non-actions which resulted in the termination. You may need this to support your case in a lawsuit.
- Don't hold back any part of an employee's salary without good reason and only after consultation with your lawyer. Most states have laws that require employers to pay salaries promptly.
- Check your company's benefit plans and be sure to pay the terminated employee any accumulated money due.
- Before the employee leaves, make sure all property belonging to the company is returned. This can include such items as: customer list, financial statements, projections, legal contracts, and marketing plans.
- Review any employment contracts for potential problems (e.g., you must give three months' written notice) before terminating any employee and check with your lawyer about enforcing any noncompete, confidentiality, or trade secret provisions.
- Check the company's bylaws and stockholder agreements for obligations. For example, the executive may have the right to sell his or her stock back to the company or you personally within a certain period of time. Pay attention to the time period and arrange for the cash needed to purchase the stock.
- When notifying your customers and employees that the executive is no longer with the company, be careful that your wording doesn't bring on a libel or slander suit.
- Don't forget to ask the employee or executive for office keys, company credit cards, and his files on the company's business.

Before firing a hostile employee or one with an employment contract, ask your lawyer to review your written memorandum of the reasons for the dismissal as well as any legal documents or memos related to his employment.

In summary, an employment contract or memo of understanding is *not* a guarantee. But it does provide some protection for both the employer and employee in the case of misunderstandings and disagreements. It's good business practice to spell out the details of employment and the penalties for nonperformance.

### **Events for Automatic Termination**

The following actions by an executive/employee will automatically terminate employment:

- A breach of or material default under the provisions of the agreement or the employer's written employment policies.
- Engagement in any business in competition with the employer, either directly or indirectly, as an employee, owner, partner, director, consultant, agent, or other position.
- Dishonestly, conviction by a court or law for fraud, embezzlement, felony, or sexual harassment
- Violation or disclosure of the company's trade secrets, inventions, patents, and other proprietary information, such as a marketing plan, customer list, and business plan.