Executive Employment Agreement Insights: From High Stakes to Competing Interests

A Lexis Practice Advisor® Practice Note by Mark Poerio, The Wagner Law Group

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This practice note addresses issues that often arise 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. 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.

The topics addressed are organized in the following sections:

- Introduction
- Precise vs. General Terminology
- Getting Started Well
- Termination Scenarios and Protections
- Taxes, Disputes, and Boilerplate

For additional materials on this topic, see Executive Employment Agreement Resource Kit.

Introduction

After drafting or reviewing hundreds or even thousands of employment agreements, the exercise can become rote. 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 vs. 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

Employer 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.

Executive Perspective

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

Employer 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.

Executive Perspective

The anticipation of a new job often clouds executives to the significant costs and risks associated with a significant relocation. 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

Employer Perspective

It normally makes sense to correlate the term of the agreement to the term of the loyalty covenants discussed under "Restrictive Covenants" 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.

Executive Perspective

A long-term agreement may seem desirable, 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

Employer Perspective

Locking in salary at a fixed level for several years is often simplest, with cost-of-living escalators being reasonable to include.

Executive Perspective

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

Employer Perspective

Maximizing company discretion is generally best, 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.

Executive Perspective

The uncertainty of a new position may justify 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.

For additional guidance, see Incentive Bonus Agreement Design and Bonus Agreements: Key Drafting Tips.

Stock Awards

Employer 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.

Executive Perspective

Restricted stock or units (RSUs)? Stock options? Performance awards? Deferred payouts? The range of alternatives warrants close attention to assure an executive receives the desired incentive on terms and conditions that are suitable and tax efficient. For start-ups, 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 (LLCs) or partnerships may also deliver capital gain treatment. (See Profits Interests as Incentive Compensation.) 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 be the vesting terms? And the expiration date for stock options?

For more information on the different kinds of equity awards, see Equity Compensation Types and Tax Treatment.

Health Insurance and Other Benefits

Employer Perspective

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.

Executive Perspective

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. 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

Employer Perspective

From a governance perspective, perquisites are an irritant whose toxicity usually outweighs the dollars involved. It is generally better to replace them 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.

Executive Perspective

Increased salary is often better for an executive 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 (ISS) and Glass Lewis. For a comprehensive list of problematic practices identified by ISS, see ISS, U.S. Compensation Policies: Frequently Asked Questions (Dec. 20, 2018).

Restrictive Covenants (Noncompetes; Non-solicits; Trade Secrets)

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, non-solicitation, trade secret, and confidentiality provisions.

Employer Perspective

Overly broad or generic post-employment covenants open 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 whistle-blower 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's fees in a federal action against an employee who divulges employer trade secrets. 18 U.S.C. § 1833(b)(3).

Executive Perspective

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.

For both non-jurisdictional and state law specific guidance, forms, and checklists in the employment context, see Restrictive Covenants Resource Kit.

Termination Scenarios and Protections

Severance

The terms and conditions for severance involve a high stakes combination of business, legal, and tax considerations. Whether the interests are those of the employer or an executive, attention to the details of particular severance events generally has material impact, although the implications are often not appreciated until a termination of employment becomes imminent or occurs unexpectedly.

Release Requirement

Employer Perspective

There is a sound reason for the routine practice of conditioning severance on an executive's execution of a claims release, namely, who would want to pay severance and then be sued for more? Employers may find themselves cornered if an employment agreement promises severance but omits a release requirement.

Executive Perspective

If an employer does not require a release of claims, that should come as a pleasant surprise to the executive. On the other hand, an executive who faces a release requirement should at least seek to limit it to the standard form the employer uses. It is even better to attach the current form as an exhibit, both to get a sense of what to expect and to have an opportunity to challenge the employer's later efforts to significantly broaden the release terms.

On occasion, a senior executive has the leverage (and budget) to negotiate the terms of the required release, and that generally is beneficial. For instance, most employers require a non-disparagement provision but are reluctant to offer that protection to terminated employees. Nevertheless, it is difficult for an employer to argue against mutual assurances of non-disparagement, especially at the start of a new employment relationship.

For-Cause Termination

Employer Perspective

In the interest of being concise, many employers opt for "cause" definitions that single out a few obvious trigger events (e.g., conviction of a felony, theft, dishonesty, insubordination). Employers should nevertheless bear in mind that insofar as reasonable, the longer the list, the greater the protections.

Executive Perspective

Because a for-cause termination triggers extreme consequences (from lost benefits to reputational damage), subjective measures such as incompetence warrant concern and attention. Also, with respect to trigger events relating to workplace conduct (in contrast to a felony conviction), it makes sense to seek due process protections such as notice of the alleged misconduct, an opportunity to be heard, and an ability to cure.

Without-Cause Termination Severance

For both parties, the core questions revolve around the executive's severance benefits for a termination without cause: what, how much, and when?

Employer Perspective

The simplest construct involves promising a multiple of salary. That approach may work below the C-suite. However, senior officers typically receive severance that takes into account their most recent bonuses (actual or target level) as well as full or partial accelerated vesting of stock awards and the continuation of employer-subsidized health benefits. Survey data about peer practices warrants consideration to determine appropriate severance levels. Publicly available survey data is available here.

"Garden leave" often makes sense as a vehicle for severance, especially for employers who desire to sideline an executive in order to effectuate a strategy for retaining key clients, customers, and employees. Paying severance over time, rather than in a lump sum, also encourages executives to honor their post-employment covenants relating to trade secrets, non-solicitation, and noncompetition.

Executive Perspective

It makes sense, of course, to maximize severance and to collect it as soon as possible after termination of employment. See above for a link to survey data, because negotiations for severance often turn on industry practices, not to mention the relative strength of each party's bargaining position.

Resignation with or without Good Reason

Employer Perspective

It is common to pay no severance if an executive resigns without good reason. For senior executives, a carefully designed good-reason provision generally provides the same severance that is promised for a without-cause termination. A minimum notice period before resignation could assist with transitions, especially when coupled with a garden leave alternative that the employer may elect to impose (and pay for by retaining the executive on payroll as an active employee for the garden leave period).

Executive Perspective

The terms and conditions for a good-reason resignation, with severance benefits, tend to track the safe harbor definition and processes that are set forth in regulations under I.R.C. § 409A, which governs taxation of nonqualified deferred compensation. Nevertheless, tweaks to that definition can create material protections for an executive.

Death or Disability

Both parties to an employment agreement have an interest in being sure to identify how much is payable and under what terms.

Rabbi Trust for Nonqualified Deferred Compensation

A trust of this kind enables an employer to deposit funds with an independent financial institution and then to use those funds to pay future deferred compensation or severance benefits. Income taxation for the executive is deferred until trust payments are made, provided that the assets of the trust remain subject to the claims of the employer's general creditors. As a result, rabbi trusts are said to provide executives with "change of heart" protection (against having the employer renege on payment), but they cannot protect against an employer's bankruptcy.

Employer Perspective

Most employers omit rabbi trust protections from their employment agreements and instead establish rabbi trusts as a complement to their deferred compensation programs.

Executive Perspective

Although rabbi trust protections are almost never offered for standard severance situations, a senior executive with leverage could reasonably seek to include a "springing" rabbi trust provision within an employment agreement. The springing provision would require funding of the trust upon a change in control and could be structured to enable the executive to collect post-closing severance directly from the rabbi trust. This construct will reduce the executive's risk of having to litigate against an acquirer who resists paying.

Change in Control

Principal terms for change-in-control benefits include the definition of change in control, the amount payable, and the inclusion of a protection period. (See "Golden Parachute Provisions" further below for I.R.C. §§ 280G and 4999 tax considerations.)

Change-in-Control Definition

Both parties have a shared interest in thoughtfully defining what does—and does not—constitute a change in control, because that event usually triggers enhanced severance benefits.

Amount Payable

If an executive's employment terminates on or after a change in control, the employer often provides an increased multiple of termination pay or some accelerated vesting of the executive's stock awards.

Protection Period

Employer Perspective

Exclusively post-transaction protected periods are the norm. It is quite uncommon for employers to provide enhanced change-in-control benefits to executives who terminate employment before a closing.

Executive Perspective

An employment agreement could identify a protected period (such as one month before the closing) when an eve of closing involuntary termination would result in the payment of change-in-control benefits.

For additional materials on severance-related topics, see Severance Benefits Resource Kit.

Taxes, Disputes, and Boilerplate

Taxes

Withholding

For drafting and negotiation purposes, Davidson v. Henkel Corp. is instructive to consider. 2015 U.S. Dist. LEXIS 722 (E.D. Mich. 2015). That litigation arose because the employer mistakenly failed to withhold Social Security (FICA) taxes on the participant's nonqualified deferred compensation plan account as it became vested, thereby causing the executive to pay otherwise avoidable FICA taxes as plan distributions were made during retirement. In ruling for the former employee, the court noted that failing to apply withholding in a manner that would reduce the participant's tax burden was inconsistent with the "design and purpose" of the plan, which—as a deferred compensation plan—includes advantageous tax treatment.

Employer Perspective

With an eye toward avoiding claims of the kind asserted in the ***Henkel*** case, employers should avoid having an employment agreement (or benefit plan) hardwire how FICA and employment taxes will be handled (even implicitly).

Executive Perspective

It is tough to constrain employer discretion over withholding terms, but being proactive about how withholding taxes apply to nonqualified deferred compensation can avoid bad surprises such as those Davidson suffered in the *Henkel* case due to the employer's oversight.

Golden Parachute Provisions

Employers lose tax deductions, and executives incur excise taxes, when a change in control triggers golden parachute penalties under I.R.C. §§ 280G and 4999. Although that creates a mutual interest in avoiding violations, the parties often differ about how best to fend off future problems.

Employer Perspective

The most basic precaution involves automatically cutting back severance (along with other amounts treated as parachute payments) to the golden parachute limit (roughly three times pay). See Section 280G Clause (Safe Harbor Cutback).

Executive Perspective

There are a variety of alternatives, sometimes called modified or limited cutbacks, that are more favorable to the executive than an automatic cutback. See Section 280G Clause (Valley or Net-Best Cutback).

Interestingly, the omission of any provision relating to golden parachute taxes can also work, because the parties would then negotiate at the time of a change in control to figure out how best to address any golden parachute implications. Because the golden parachute penalties can be so severe, waiting until the last minute is nevertheless a risky strategy. Everyone positions better to run golden parachute calculations well in advance, in order to consider precautions and to avoid later surprises.

For more materials on the golden parachute rules, see Section 280G Resource Kit.

Section 409A

In addition to ordinary income tax, an additional 20% tax and late payment penalties could result from compensation, stock award, and severance programs that violate the nonqualified deferred compensation rules set forth in Section 409A. Concern should arise any time compensatory payments could occur later than the calendar year in which vesting occurs, with a particular tax nightmare looming if the exercise price for stock options does not reflect (at minimum) a good faith determination of the fair market value of the underlying shares as of the grant date.

For a checklist by which to identify potential Section 409A problems, see this webpage. See also Equity Award Drafting Checklist (Section 409A Compliance), Fair Market Value Determination for Section 409A Stock Rights Exception, Section 409A and Severance Arrangements, Section 409A Six-Month Delay Rule Compliance, and other relevant materials in the Section 409A Resource Kit.

Employer Perspective

It is common for employment agreements to address Section 409A in two ways. On the one hand, most agreements include extensive compliance-oriented provisions to address timing issues associated with reimbursements, the six-month delay rule for specified employees of public companies, and a savings mechanism (to support interpreting the agreement to avoid Section 409A violations).

On the other hand, there is ordinarily an express disavowal of employer liability for Section 409A penalties, as well as any other taxes imposed on income that the executive recognizes pursuant to the employment agreement. Significantly, in this regard, Section 409A's 20% excise tax and late payment penalties are imposed on executives, with the employer merely having the legal obligation to report violations and to make required income tax withholdings.

Executive Perspective

Although employers lead the drafting of employment-related agreements and equity awards, it is exceedingly rare for an employer to agree to indemnify executives for Section 409A taxes and penalties. As a result, executives should have their own Section 409A counsel provide a compliance review, especially for high-dollar agreements. Otherwise, a later discovery of Section 409A defects could find the executive bearing the tax loss. That occurred in Wilson v. Safelite Grp., Inc., 930 F.3d 429 (6th Cir. 2019) (affirming dismissal of plaintiff's suit against former employer for Section 409A taxes incurred by plaintiff arising from defective deferral elections under Section 409A on ERISA preemption grounds).

Indemnification

Employer Perspective

It generally suffices for an employment agreement to be silent on indemnification, on the premise the executive will have the same protections that the employer provides for other similarly situated officers and directors.

Executive Perspective

Express provisions will often secure firmer assurances and protections—sometimes merely peace of mind. Note that indemnification protections can come from three main sources: insurance, the employer's governing documents (e.g., bylaws), or separate contractual provisions or agreements.

For sample language, see Indemnification Clause (Pro-employer) and Indemnification Clause (Pro-executive).

Dispute Resolution

Attorney's Fees and Other Costs

Employer Perspective

It generally benefits the employer to have the parties pay their own litigation expenses. This results if the employment agreement omits any provision about fee recovery.

Executive Perspective

A rough justice approach involves allowing the party who substantially prevails in a dispute to recover costs from the losing party. It is even better for an executive to merely secure a right to recover from the employer if the executive substantially prevails (but not vice versa).

Governing Law, Arbitration, and Exclusive Forum

Each party has an interest in litigating under the most favorable state law, in the most convenient place. Counsel for each side will normally weigh the alternatives and make recommendations. With respect to dispute resolution through arbitration, employers should generally ensure that their employment agreements reflect the employer's general preference for whether or not arbitration or mediation will be applicable and the terms of the alternative dispute resolution process. Executives will need special counsel to evaluate fair and reasonable protections and mechanisms for dispute resolution terms under the circumstances.

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For 30 years, Mark has been in private practice with a focus on executive compensation, employee benefits (especially ESOPs), and retirement plan fiduciary matters, not only from a tax and labor perspective, but also from a business, governance, tax, securities, and litigation perspective. He currently serves as immediate Past President of the prestigious American College of Employee Benefits Counsel after previous terms as its Treasurer, Vice-President, and President. Mark is Chambers-rated, and works regularly with the American Benefits Council (where he was an executive board member for many years).

Mark's clients include public and private companies; he also has significant experience with not-for-profit organizations from both a governance and a executive compensation perspective. His business oriented pay-for-performance approach has led to his role as special counsel to compensation committees, as well as to his spearheading of projects designed to link executive compensation to corporate goals and to the enforcement of post-employment covenants relating to trade secrets and restrictive covenants (such as non-competition agreements).

Mark also teaches at Georgetown Law School. His courses have focused on executive compensation and governance, the design of benefit plans and employment-related agreements, and employee stock ownership plans (ESOPs).