

**HARVESTING THE WEALTH:  
TIPS FOR EMPLOYERS TO CONSIDER WHEN NEGOTIATING EXECUTIVE  
COMPENSATION ARRANGEMENTS**

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Most of my clients are small to medium-sized businesses and many of my clients like to work on the basis of “trust,” especially when dealing with their senior-most executives within the Company. Believe it or not - I still have a few clients that do business with vendors and clients through “handshake” deals, although I have persuaded most of them to at least document those deals through follow up emails and correspondence.

Given that I have spent about 50% of my professional time in the last 21+ years dealing with disputes between individual employees and employers where trust issues have broken down, I encourage my business clients to “trust” their employees, particularly executives, but to clearly document what the executive/employee is being “trusted” to do, what is not within the employee/executive’s perview and what the consequences will be for meeting stated objectives and/or failing to meet those stated objectives. Documenting employee’s obligations, as well as the employer’s expectations, assists businesses work towards optimal performance management. And, documenting the obligations of the employer in the full panoply of possible scenarios that could occur in the employment relationship, including an unpleasant termination, reduces the chance of a dispute later. Employment litigation is costly - both in terms of dollars and distraction from the business. Spending a much smaller amount of money on the front end of the relationship to create agreements that clearly document the employer and employee’s

understandings about expectations, compensation and possible termination of the relationship, in my experience, is a much more rewarding endeavor.

As you can tell, I believe in clearly-written employment agreements for key employees, particularly the executives in the organization. And, over the last decade, it has become increasingly more commonplace for key executives to expect to have a written agreement outlining their obligations and compensation arrangements in advance of the commencement of their employment.

The concept of documenting the expectations of employees in the employment relationship has been around for a long time. (Indeed, there is a Minnesota statute [more than 55 years old] that requires employers to put the terms and conditions of employment in writing at the commencement of employment [Minn. Stat. 181.55]; in fact, under Minnesota law, if an employer fails to put the terms of employment in writing, it is the employer's burden of proof to show what terms of employment apply to the employment relationship. Minn. Stat. 181.56. By its language, Minn. Stat. 181.55 makes clear that it was written with hourly employees in mind, as it requires written communication about: the date employment began, rate of pay, number of hours worked each day and whether overtime will be paid for extra hours worked, and any "special responsibility undertaken by the employee . . . which, if not properly performed, will entitle the employer to make deductions from wages.") I have often wondered why executive level employees in Minnesota do not attempt to use Minn. Stat. 181.55 and 181.56 to try to argue that the employer has the burden of proving certain terms of an employment relationship (e.g., arguing the employer has the burden to justify any failure to pay bonuses, since it arguably amounts to "an offset from wages.") Admittedly, that statute does not neatly fit the typical executive compensation situation, but it serves as a good reminder that employers would be wise

to document the specific items listed in the statute for every employee (start date, etc.) and document in detail the terms of key employment relationships.

## **OVERALL GUIDELINES**<sup>1</sup>

### **1. BE DIRECT AND DON'T BE "CLEVER" IN YOUR NEGOTIATIONS AND DEALINGS WITH EXECUTIVES.**

The writing that you ultimately agree to with respect to your employees (whether it is an offer letter or a formal employment agreement) should be straightforward and address the issues between the parties head-on. The executives and/or employers that I've dealt with who try to hide the ball or cleverly draft around a particular issue that is not squarely addressed between them inevitably end up in disputes later in the relationship.

Obviously, compensation, expectations and obligations as between employer and employee are typically some of the first discussions you have. How these communications are handled will impact communication expectations for the rest of the relationship. If an employer is candid, well-prepared and organized, reasonable and forward thinking with respect to these discussions, that will set the tone for other interactions down the road. It is my position that this is what you should expect from you employees - particularly senior executives: candor, thorough preparation, addressing issues in a meaningful and organized way, reasonableness (and flexibility) and forward-thinking vision. Furthermore, we know that modeling expected behaviors is one of the best ways to favorably impact performance.

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<sup>1</sup> This is not meant to be an exhaustive list. Rather, this author spent some time reflecting on executive negotiations in which she participated, or litigation or other contentious disputes handled involving executive compensation issues and distilled some "lessons learned" from those experiences. I've taken the time to list those "lessons" here. Of course, it is always best to thoroughly review each individual executive compensation situation with savvy employment counsel.

**2. CLEARLY STATE WHETHER THE WRITTEN AGREEMENT BETWEEN THE PARTIES ADDRESSES ALL THE ISSUES BETWEEN THEM AND “TRUMPS” ALL THE OTHER DISCUSSIONS BETWEEN THE PARTIES.**

A business client who we are representing in the handling of the post-employment dispute with one of its former employees recently said to me, “I normally just blow through all that ‘boilerplate stuff’ you put in our employment agreements, but now that we are in this big fight with our former employee, those boilerplate clauses are really useful.” A couple of boilerplate provisions that should be in all employment contracts (to make clear that what is written in the document is all that counts and “trumps” prior discussions) are:

- **The Employee/Executive Is Relying On Nothing Other Than What Is In The Four Corners Of The Agreement.** In legalese, an agreement should say something like: “The undersigned Employee acknowledges that the Employer has made no representations to Employee regarding any aspect of the employment relationship other than those representations specifically contained in this Agreement. In signing this Agreement, the Employee represents that s/he has not relied on anything outside the confines of this Agreement to induce him/her to sign this Agreement.”
- **If Appropriate, Note That This Employment Agreement Is The Only Document That Governs The Employment Relationship.** Oftentimes, employment agreements contain language such as, “This Agreement represents the entire agreement between the Company and the Executive with respect to the employment of the Executive by the Company and this Agreement supersedes all other (including prior) oral or written communications between the parties about

the employment relationship. This Agreement may be modified only in a writing executed by the CEO of the Company and the Executive.” “Entire agreement” and “no modification” clauses are good, but we need to make sure their contents are *accurate*. (In other words, we as employers have to read all of the boilerplate language that our lawyers provide to us and make sure it tracks with the factual situations at hand.) There may be other documents that govern the employment relationship, such as benefit plans, stock option agreements, bonus plans, etc. So, it may be more appropriate to refer to the other plans that govern the relationship right in the document, noting which document [the plan or the employment agreement] takes precedence over the other.<sup>2</sup> Or, a more accurate “entire agreement” clause might note that the Employment Agreement is the entire and final agreement “with respect to the matters addressed therein [rather than the entire employment relationship].”

- **The Employee Has Read The Agreement And Understands It.** Most good employment agreements contain a boilerplate provision something like: “I, the undersigned employee, state that I have been provided enough time to read this Agreement, I have read it and understand its terms and I am knowingly and voluntarily executing this document.
- **The Employee And Employer Worked Together On The Language In The Contract.** As many of us in this room are aware, if there are ambiguities in a contract, those ambiguities are typically resolved, in court, against the party who drafted the agreement. I am continually amazed by how different folks can read the same contract provisions to mean different things. Therefore, employment

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<sup>2</sup> See comments in benefits section below.

agreements should contain language like, “The parties agree that each party has contributed to the drafting of this Agreement and, therefore, no rules of construction may be applied to this Agreement to construe it against one party and in favor of another.”

### **3. HOW LONG ARE YOU GOING TO BE COMMITTED TO ONE ANOTHER AND FOR WHAT REASONS WILL YOU PART?**

You need to decide: do you want a fixed or a variable “term” for the agreement? Of course, be mindful, if you have a specified time period that allows the company to get out of the contract or a defined period during which you must renew the terms of a contract, you need to tightly calendar and comply with those deadlines. Many employers try to get an “at will” provision in all employment agreements, including agreements for executives. Some executives insist on termination only for cause. Therefore, it will be important to appropriately define cause. Some thoughts on the subject of cause include:

- Reserve the right to terminate an employee for cause if s/he has undertaken acts that are illegal, dishonest or materially in violation of the company’s policies. With respect to termination for these types of offenses, you do not want to say anything that requires an employee is convicted or “proven” to be guilty of this conduct. You want to be free to terminate for cause, rather than wait until after litigation (criminal or civil) is completed in order to have a determination of the conduct.
- Reserve the right to terminate an employee who has materially failed to perform the duties assigned to him or her by the person to whom s/he reports or the Board of Directors. Many employees will want notice of the failure to perform and an opportunity

to cure any failed performance. Of course, employers can include such a provision if they want to do so. But, if you have the word “material” in the cause definition related to performance, that should be enough to appease most executives on this issue.

- Reserve the right to terminate an employee who has engaged in any conduct that materially injures the company or conduct that is likely to materially injure the company, its reputation or its business relationships. Optimally, your agreement will reserve the right for the Board to make the determination whether the employee’s conduct meets this definition.
- Reserve the right to terminate the employee/executive for any violation of the employment agreement.
- DO NOT RESERVE THE RIGHT TO TERMINATE AN EXECUTIVE/EMPLOYEE IF S/HE BECOMES DISABLED. So many template employment agreements, often drafted by long-time business lawyers, contain provisions that may violate the Minnesota Human Rights Act, the federal discrimination laws or other state’s laws. Two such common provisions I see are:

(a) Termination for Death and Disability. While it is certainly reasonable to terminate the employment relationship when a person passes away, it is unwise for an employer to be in the business of assessing an employee’s disability.

Under the employment laws, employers have a duty not to discriminate against persons with disabilities and to reasonably accommodate those disabilities.<sup>3</sup>

(Notably, in Minnesota, employers’ obligations with respect to reasonable accommodation are greater than in many other jurisdictions. For example, a

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<sup>3</sup> Because the issue of reasonable accommodation is addressed in detail in another section, “Rotating the Crops,” I am not addressing the subject of required reasonable accommodation in detail here. You should reference those materials for more information on that subject.

Minnesota employer has the burden to prove that a requested accommodation is not reasonable, once the employee requests that accommodation. Minn. Stat. 363A.03. Moreover, a Minnesota employer can only refuse to hire or work with a disabled employee, due to her inability to do the job, if s/he cannot perform the essential functions of a job *with* reasonable accommodation [rather than *with or without* reasonable accommodation, as is the standard under the federal law].) Minn. Stat. 363, subd. 36(1). Therefore, my advice is to know as little as possible about your employee's health, so that you cannot be accused of discriminating against those employees because of their health issues or accused of failing to reasonably accommodate an employee who did not request reasonable accommodation, but whose need for accommodation is open and obvious. Perhaps most importantly, it is not *necessary* to have the provision that allows an employer to fire a disabled employee. If an employee is disabled and doing a wonderful job, most employers could care less about that employee's health status. Rather, it is only the employees who cannot perform their jobs that employers want to fire. Those employees should be fired under the cause provisions that allow employers to end an employment relationship because the employee/executive is materially failing to perform.

(b) A termination clause that allows for termination in the event of a failure to act like an executive - e.g., abusing alcohol. You will also want to be mindful of cause provisions that allow for termination of employees for conduct that is "unbecoming" an executive, such as "abuse of alcohol." Under Minnesota law, an employer may not take disciplinary or other adverse action against an

employee because the employee “engages in or has engaged in the use or enjoyment of lawful consumable products, if the use or enjoyment takes place off the premises of the employer during nonworking hours.” See, Minn. Stat. 181.938.

More executives are also asking for the right to terminate an agreement with a specified term early for “good reason”. This is a phrase that should be defined as well. Typical “good reason” language includes:<sup>4</sup>

- Material diminution in the executive’s authority, responsibilities, position and/or title;
- Material diminution in the executive’s overall pay, unless it was in connection with an overall compensation reduction company-wide and in the same percentage as the other employees experienced in the company-wide reductions (Note: It would be unwise to focus only on base compensation, since that could be an insignificant issue in the overall compensation scheme);
- A material change in the person (or the level of the person) to whom the executive reports;
- A material reduction in the overall financial responsibility of the employee (e.g., a reduction in the budget for which the employee is responsible);
- A material change in the location where the executive is required to work, or a material increase in the travel required for the position; or
- A breach of the employment agreement.

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<sup>4</sup> There is a tax issue relevant to terminations of executive compensation agreements. An excise tax might apply that adversely impacts both the employer and employee. 409A requires that, in order for a separation from service to be exempt from excise taxation, it must be an “involuntary termination”. Art Glassman’s materials will provide more insight on this subject.

#### 4. WHAT DO YOU EXPECT FROM YOUR EMPLOYEE/EXECUTIVE?

**Specifically Describe What You Expect From Your New Executive.** Oftentimes, I see employment agreements that merely state that the Executive will perform duties, as will from time to time be assigned by management and are consistent with the types of duties assigned to persons holding similar positions. Why not attach a job description? It will force the executive/employee and the new employer to clearly articulate what is expected from the employee. At a minimum, consider specifically articulating benchmarks which will determine whether the employee is viewed as a success. Even if you are start-up company and you are not quite sure what the job will entail, certainly there are key accomplishments (such as securing financing, hiring the key staff, developing a business plan, etc.) Of course, it will be important to reserve the right to assign other objectives and/or work that you did not put in the job description or benchmarks for success. Nonetheless, having the discussion, in detail, about duties, expectations and benchmarks in advance will serve both parties well.

**If you have an exclusivity provision, define what it means.** Many agreements contain language that requires an employee to devote all of their professional energies, skills, abilities and efforts “exclusively” to their employer. What does this mean? Can the executive serve on a Board of another organization? What about outside financial investments? Charitable contributions? Volunteer work? If s/he can only engage in these quasi-professional endeavors with management’s consent, that should be specifically articulated in the agreement. (Some of these items seem rather trivial, like volunteer work, but I have represented employers in disputes involving that very issue; e.g., the executive undertakes volunteer work for a rather fringe organization that appears to take a position that could negatively impact the company.)

## **5. BE REASONABLE WITH RESPECT TO NONCOMPETITION AGREEMENTS AND SAVE YOURSELF IF YOU ARE TAKING AN AGGRESSIVE POSITION.**

If you are asking your employees/executives to sign a noncompete agreement, bear the following in mind:

- Noncompetes<sup>5</sup> should be raised in the interview process, provided to the employee to consider prior to the commencement of employment and executed prior to the commencement of the employment relationship. If noncompetes are executed post-employment, for a Minnesota employee, additional compensation must be provided to the employee/executive.
- All noncompetes must be geographically and temporally reasonable.
- **Hedge your bets regarding the enforceability of noncompetition language.** Savvy employers are including “blue pencil” language as part of the boilerplate language in executive compensation agreements, especially those that include noncompetition and/or nonsolicitation provisions. This language could improve the chances that the court will enforce a noncompete, even if the court views the language as too broad, by narrowing it to be only as broad as the court believes is appropriate. In legalese, such a provision should say something like: “If a court finds any term of this Agreement to be invalid, unenforceable, or void, the parties agree that the court shall modify such term to make it enforceable to the maximum extent possible. If the term cannot be so modified, the parties agree that the term shall be severed and all other terms of this Agreement shall remain in effect.”

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<sup>5</sup> Once again, since the issue of protecting your intellectual property, including utilizing noncompetes, is addressed in another section, “Using the Miracle Grow Secret,” I am not addressing the subject of noncompetes in detail here. You should reference those materials for more information on that subject.

## 6. CLARITY ON COMPENSATION IS KEY

Most employers do a pretty good job making clear for executives how the compensation programs will work, so I won't go into great detail on this subject, except to highlight a few issues about which I've seen a number of disputes.

- **Reserve The Right To Decrease Pay If That Is Appropriate.** Many executives believe that their compensation can only be increased and never decreased, based on the language in employment agreement, which typically provides something like, "employee will be paid X amount." If all parties concerned agree that only increases in pay are contemplated, then such language is fine. If, however, management wishes to reduce pay, if appropriate, the agreement should clearly allow for such reductions.<sup>6</sup>
- **List all forms of compensation and how each will be determined.** Employees and employers often have disagreements about what is *not* in the contract.<sup>7</sup> Whether or not an employee has a legal right to assert an entitlement to something outside the contract, employers are well-served to communicate clearly on what is often the single-most important item to an employee - compensation.
- **Bonus Entitlement.** If an employer wishes to have the exclusive right to assess whether the benchmarks necessary to trigger a discretionary bonus have been met, the agreement should specifically note that right. Alternatively, that

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<sup>6</sup> Of course, in such a situation, the good reason language would need to track the compensation language, so the employer is not unknowingly allowing the employee to resign (and potentially receive severance) by reducing compensation.

<sup>7</sup> This is one of the reasons that I suggest putting in the boilerplate terms suggested in Guideline No. 1 noting that the agreement "trumps" all other documents regarding the employment relationship, including pay. Even with those provisions, employees sometimes claim there was a misunderstanding with respect to some component of pay because it was not specifically addressed in the employment agreement.

decision could be designated as a Board decision or subject to arbitration or some other alternative dispute resolution. Be mindful that you may have a good a generally employee that you don't want to lose over this bonus dispute. Thinking about ways for the employee to feel heard, without losing the employee or giving up the right to control bonuses, may be prudent.

#### **7. IF YOU CAN, DO NOT “SAVE” THINGS TO BE RESOLVED LATER.**

While I realize that it is impossible to cover every item in the employment agreement, it is important to be clear about issues that are reserved and handle those in as much detail as possible. For example, in a start-up situation, the employer may wish to promise that an executive will participate in a bonus program or a stock option program to be developed later. Optimally, at a minimum, the agreement will set forth whether these programs will be at the employer's sole discretion, or whether they programs need to be approved (prior to adoption) by the executive. Similarly, most executives will request that the agreement set forth a time frame for adoption of those additional programs.

#### **8. BENEFITS/PERQS**

Unless you have clear policies in existence already on this subject, your employment agreement should address whether there are caps on business expenses, the approval process (noting whether advance written approval is required for a certain level of business expense) and a time limit for submitting expenses for reimbursement. If you have those policies clearly set forth elsewhere, you should consider referencing those policies in the employment

agreement and note that they may be changed from time to time by the employer, at its discretion.

Relocation can be costly and that is an issue that should not be left for “later” to iron out. Optimally, there would be a specific understanding on this issue that is documented in the employment agreement.

Interestingly, as the world is getting more mobile (and, therefore, turnover is more frequent), vacation disputes have become more prevalent. While the parties may agree that the executive is entitled for four weeks vacation, is this accrued over time or available upon commencement of the employment. Similarly, what amount of unused vacation rolls over from year to year should be communicated clearly between the parties. Of course, this is more important for Minnesota employers in light of the Fresenius<sup>8</sup> decision addressing payment of accrued vacation upon termination.

The higher the executive, the more likely that other benefits will be an issue, such as retiree medical, club memberships, etc. Clear documentation on those issues will avoid disputes later.

## **9. IF THERE IS A DISAGREEMENT, IN WHAT FORUM ARE YOU GOING TO FIGHT WITH THE EXECUTIVE AND WHO PAYS?**

- **Jurisdiction and Venue**. I see many executive compensation agreements that provide that Minnesota law applies to the interpretation of the agreement, and the parties agree that they are subject to the jurisdiction of Minnesota courts and agree to venue the case in a particular place in Minnesota. However, what about

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<sup>8</sup> Lee v. Fresenius Medical Care, Inc., 719 N.W.2d 222, 153 Lab.Cas. P 60,270 (Minn.App. Aug 08, 2006) (NO. A05-1887), review granted (Oct 17, 2006).

the rest of the disputes between the parties about the employment relationship that are not specifically addressed in the agreement (e.g., discrimination claims)?

Where will they be venued? I prefer language that makes clear that *any* dispute about the employment relationship *at all* will be governed by Minnesota law, with jurisdiction and venue in Minnesota. In legalese, such a provision might say, “Employee [or the parties] irrevocably submit[s] to the jurisdiction and venue of the state and/or federal courts located in the State of Minnesota for any action or proceeding regarding this Agreement, his or her employment with the Company [or the employment relationship] or the termination thereof.”

- **Arbitration; is it right for you?** Some employers still prefer arbitration because it is private; however, many have concluded that arbitration is just as expensive as litigation and often results in “split the baby” determinations. If you are going to agree to arbitrate, of course that is up to you. In doing so, you need to be mindful that the right/duty to enforce the noncompete/nonsolicitation provisions should be in court and add appropriate language to the agreement.
- **Attorneys’ fees and costs.** What happens if there is a dispute and/or one party is forced to enforce the agreement because the other is not complying? Many executive compensation agreements have a prevailing party pays attorneys’ fees and costs provision. This is an important incentive that encourages the parties to comply with the understandings documented in writing. However, we also need to be mindful of “partial” victories. For example, you could consider including language like, “If neither party wholly prevails, the party that receives substantially the relief it sought, whether by dismissal, summary judgment,

judgment or otherwise, shall be awarded all of its reasonable attorneys' fees and costs incurred in connection with such controversy, claim or dispute.”

## **10. CONSIDER TAX ISSUES.**

The tax laws have become much more complicated in the post-Enron era, especially relating to sizeable payments to executives. To try to deal with those new complexities, executives are often asking for the employer to assume the risks of certain tax treatment as part of their employment agreement. For example, be prepared to address items such as:

- 280G Gross-up
- 409A Gross-up and alterations for schedules for payment.

With respect to taxes, like all of the other issues addressed in this article, it is best to address these issues in advance.

The tips provided in this article are designed to facilitate a more productive interaction between employers and their executive employees. Obviously, we stand ready to assist with respect to the details of any executive compensation negotiation at any time.