FOUNDER FOCUS

Patterson Belknap

Key Employment Issues for Founders

Do you have an employment agreement? Should you have an employment agreement? We are often asked whether founders need written employment agreements with their companies. Every company's culture is different. Often founders are at-will employees who can be terminated (or can quit) for any or no reason. They may have an offer letter but no employment agreement. In other situations, founders or investors demand that the company put employment agreements in place with key personnel.

Whether founders have employment agreements or not, they should be familiar with several key employment concepts that affect their rights, compensation, ownership, and control.

Vesting (and re-vesting). Equity grants for employees are often unvested or partially vested at grant and then vest over a period of time. If the employee ceases to provide services, the unvested shares are typically forfeited or repurchased by the company. Sometimes the company repurchases the shares at their fair market value, but more often the shares are bought at their original issuance price. As a result, founders with unvested equity who leave or are terminated may lose a significant portion of their potential stake in the company they founded.

Should your initial founder shares be subject to vesting? From the founder point of view, it seems like the clear answer would be no. But some investors demand it. Some founders wish their co-founders had it. Some startup company forms include it as a matter of course.

Each situation is different and requires careful consideration. A single founder's initial shares probably do not need to be subject to vesting. However, vesting (or re-vesting) all or a portion of a founder's shares may be necessary to bring in a desired investor. In other circumstances, vesting of co-founders' shares may be the right answer to ensure that equity continues to be held by those actually building the business. Addressing misallocation of equity among founders down the road can create potential qualified small business stock (QSBS) complications and other tax problems.

In each case, vesting and the circumstances under which the company can repurchase your shares (and at what price) are key employment concepts that directly affect your ownership and should be reviewed carefully by your legal counsel before the agreements are signed.

Cause. If you are an at will employee who can be fired for any or no reason, why should you be concerned about a "for Cause" termination? Even though you are an at will employee and may not have an employment agreement, a "for Cause" termination can have a direct effect on your ownership through the vesting provisions described above and can have other consequences for control of your company. Moreover, these consequences may be the result of a definition in a company document that you never negotiated or reviewed.

For example, consider the following portions of a Cause definition that might be included in a grant agreement or stock incentive plan. The company can terminate the services of the employee for Cause upon "(i) your conviction of, guilty plea to, or entry of a nolo contendere plea to, a felony under U.S. federal or applicable state law; (ii) any act of theft of Company property, fraud, or dishonesty; (iii) your involvement in any situation which subjects you to scandal, disrepute, widespread contempt, ridicule, or which would be widely deemed by members of the general public, to embarrass, offend, insult, or

denigrate individuals or groups, or that will tend to shock, insult or offend the community or public morals or prejudice the Company in general; or (iv) any breach by you of the Company's policies and procedures."

While you may agree that conviction of a felony should be grounds for termination for Cause, should any act of dishonesty permit termination for Cause and forfeiture of equity? What about an employee's involvement in any situation which subjects him to scandal, disrepute, or ridicule? Reasonable people can disagree over what might be covered under that standard. Should you be subject to a termination for Cause as a result of a "foot fault" breach of the company's policy regarding vacation or reimbursement of expenses? Which of these events permitting a termination for Cause should be subject to prior written notice and an opportunity to cure?

Be on the lookout for Cause definitions in grant agreements and equity plans. Note that it is not uncommon to negotiate the definition of Cause, even if it means that your definition of Cause is different than the one in the incentive plan. The definition should be carefully reviewed by your legal counsel before signing applicable agreements.

Proprietary Information and Invention Assignment Agreements. These agreements are standard and important pieces of creating and protecting value in your company. Every company needs to ensure that it owns the intellectual property that its founders and employees create. However, for serial entrepreneurs, an overbroad Proprietary Information and Invention Assignment Agreement or the failure to exclude a founder's existing intellectual property rights can lead to complications not only for your current company but also for your future ventures.

Restrictive Covenants. Non-compete and non-solicit provisions can appear in employment agreements, proprietary information and invention assignment agreements, confidentiality agreements, equity agreements, and other agreements you may have with your company. Though some states restrict or prohibit enforcement of non-compete provisions in the employment context, in most jurisdictions they can still be enforced.[1] Overbroad and poorly defined non-compete and non-solicit provisions are common. Even if a company does not seek to enforce the covenants, questions about the scope and enforceability of the restrictions can complicate your relationship with new employers as well as cloud the prospects of your next venture. Founders should review the terms of all restrictive covenants closely with their own legal counsel before agreeing to such provisions.

Remember, company counsel is supposed to represent and protect the company, not the founders. In certain situations, such as the negotiation of an employment contract or equity award, the company's and the founder's interests diverge. Founders should engage their own legal counsel to review and advise on employment agreements, equity grants, shareholders agreements, and other agreements that fundamentally affect founders' ownership and control over their companies and future endeavors.

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[1] We note the recent Federal Trade Commission rule that purports to generally ban non-competes nationwide, as discussed in our client alert, available here, including the multiple ongoing court cases challenging the validity of that rule.

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact a member of the Founder Focus team:

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