

# Employment Agreements with Key Employees

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- **General Purpose**
  - Document the Employer-Employee relationship
- **Intellectual Property and Deal Aspects**
  - Provide continuity in operations; Protect Work for Hire
  - Document the pre-existing knowledge or IP of each employee
  - Non-compete, non-solicitation agreements (addressed later)
- **Initial Due Diligence Step – Review Existing Employee Agreements**
  - What do agreements say about change in control?
  - What about material change in Employee's duties?
  - Do agreements contain a non-compete, non-solicitation?

# Retention Agreements

- Positive Incentive to Stay with Company
  - Money, Stock, Options – pay to stay
  - Consider appropriate benchmarks
  - Escrow of funds or stock
- How Dependent is Success of Company upon Employees?
  - Keep top performers happy in time of change
  - Is seller's earn-out dependent upon performance of key employees?
  - Be creative with vesting schedule
    - Does employee just need to stay through closing?
    - Should additional benchmarks be incentivized?

# Retention Agreements

- Tax Consideration – consult tax practitioner
  - Seller paying bonus can be seen as additional consideration
  - Beware “golden parachutes” with adverse IRS consequences
- When to Implement
  - Generally, the earlier the better
    - Prevents re-trading by employees at time of deal
    - Keeps people engaged
  - But, consider message to the market or customers
- Who Should have Agreements?

# Take Away Points

- Review Your Existing Agreements
- Consider the Business Needs of the Buyer
- Consider the Financial Needs of the Seller
- Consider the Incentive of the Employees
- Be Creative

# Topic 1: Employment Agreements, Key Employees – Drug Distributor

- Drug distributor ( Florida) selling to independent drugstores.
- \$100 MM revenue. \$35 million purchase price. Stock deal.
- Head salesman “controlled” 30% of accounts. An employment contract “negated” in a takeover. He participated in potential buyer visits, and knew the process.
- Successful bidder made offer, contingent on new contract negotiation with this person.
- Salesman did not “hold up” the buyer for extra \$\$

# Topic 1: Employment Agreements, Key Employees – Government Contractor

- Govt contractor, \$50 MM in revenue, \$30 MM price.
- No employment contracts, but buyer wanted to sign up four executives. One of execs, held out and demanded a better deal for a colleague.
- Discussions continued up to day before closing.
- Transaction canceled by buyer.

# Non-Compete and Non-Solicitation Restrictions

# Non-Compete Agreements

- Two Basic Types
  - Employment Agreement Non-Competes
  - “Sale of Business” Non-Competes
- No unified, national body of law
- Non-Competes generally “disfavored in the law”
  - Considered “restraints of trade”
  - A few states (e.g., California) will not enforce “employment agreement” non-competes at all
  - All state laws place limits on enforceability
    - Just because the employee signed it does not mean it will be enforced by a court as written
  - “Sale of Business” Non-Competes are generally subject to less exacting review

# Non-Compete Agreements

- Non-competes must be narrowly tailored to protect a “legitimate business interest”; must be reasonable as to:
  - Definition of competitive “business” or “industry”
  - Geographic scope
  - Time duration
- No undue hardship to employee or public
  - Can’t make it impossible for employee to earn a living
  - Can’t deprive the public of a necessary service
- Harm to employer outweighs harm to employee

# Non-Compete Agreements

- Different approaches by state courts when non-compete is found to be overbroad
- “Red Pencil” states (e.g., Virginia)
  - Court will strike the entire non-compete if any portion is overbroad
- “Blue Pencil” states (e.g., Maryland)
  - Court may strike only the offending portion
- “Equitable Reformation” states (e.g., DC)
  - Court may strike the offending portion AND insert a provision that accomplishes the parties’ intent

# Non-Compete Agreements

- Hypothetical: Non-compete prevents marketing manager from working in the industry in MD, VA, DC and PA. Evidence shows he never worked with customers in PA but did work with customers in WVA.
  - Red Pencil: void entire provision
  - Blue Pencil: strike reference to PA; leave rest of provision in place
  - Reformation: strike reference to PA and add reference to WVA

# Non-Compete Agreements

- “Sale of Business” Non-Competes are treated differently by courts
- Preventing a selling shareholder from starting a new business to compete for the customers of the acquired company is part of the larger deal
- A selling shareholder is presumed to have more bargaining power than a mere employee
- Even “right to work” states like California will generally enforce a “sale of business” non-compete in a M&A deal

# Non-Solicitation Agreements

- Less restrictive than general non-competes
- Two basic types:
  - non-solicitation of customers of the former employer
  - Non-solicitation of employees of the former employer
- No uniform, national body of law; also “disfavored” as restraints of trade
- Courts are more receptive, but same sorts of considerations apply; provisions must be “reasonable” in scope (geography, time, etc.)

# Non-Solicitation of Customers

- Provides employer with direct protection for goodwill developed with the employer's clients
- Courts more receptive because they do not prevent employee from working in the industry
- Still must be limited in time and scope
- Courts may not enforce with respect to *prospective* customers absent evidence of confidential information exchanges/specific pitches
- Prohibitions on accepting unsolicited business may not be enforced to avoid harm to public

# Non-Solicitation of Employees

- Anti-raiding provisions
- Routinely enforced to protect company's proprietary information and investment in development of personnel
- Must still be limited in time to avoid undue burden on employee mobility
- Even jurisdictions hostile to restrictive covenants generally enforce anti-raiding provisions

# Non-Solicitation Agreements

- Non-solicitation provisions are less-restrictive alternatives to general non-competes
- Far more likely to be enforced
- Often included with non-competes in employment agreements
- Include severability provisions that specifically state they will remain in force if the general non-compete is found unenforceable
- Choice of law provisions also critical to maximize chances of enforceability

# Topic 2: Non-Compete, Key Employees – Staffing Business

- \$8 million staffing business sold to roll-up
- Buyer settled for one-year non-compete with owner
- Owner opened competing firm 366 days after closing
- Owner went after old customers and previous staffers

# Protecting Trade Secrets

# Protect Confidential Business Processes that are not Patented or Copyrighted

- Under State laws, certain protections are provided for Trade Secrets
  - District, Maryland and Virginia – all based upon Uniform Trade Secrets Act
- “Trade Secret” means – information, including a formula, pattern, compilation, program, device, method, technique, or process that:
  - Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
  - Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy

# Trade Secret – Deal Specific Issues

- Do you really need or want to share the “secret sauce”?
- How do you protect Trade Secrets?
  - Document information or process appropriately
  - Apply internal procedures to maintain confidentiality
    - limit access to trade secret information;
    - mark materials “confidential”; and share only on “need-to-know” basis;
    - secure sensitive files, databases, formulas, etc.;
    - require all employees, contractors and consultants to sign NDAs;
    - require key employees to sign noncompetition agreements;
    - enforce nondisclosure and noncompetition agreements

# Trade Secret – Deal Specific Issues

- How long should trade secrets be protected?
  - Beware of boilerplate “3 or 5 year” NDA
  - Trade Secrets – indefinitely
- Can you really protect and enforce Trade Secrets?
  - Yes. Injunction or Damages
  - *Hallmark Case*: In July 2014, Hallmark received a \$31 million judgment against a private equity firm for misuse of Hallmark’s trade secrets. The private equity group was found to use power point slides from its due diligence in Hallmark when pursuing another acquisition.
  - Attorneys’ fees may be awarded if Trade Secret is converted in bad faith

# Topic 3: Trade Secrets, Technology Licensing – Global Conglomerate Selling Small Division

- Global owner selling small division to US NYSE listed firm. \$50 MM revenue, \$35 MM price, asset deal. Chemical product.
- Business process and “know how” required to make the product. No patent. Process was written down in detail.
- Trade secrets based in 6 of 20 employees. Only divisional CEO had employment contract, but null in asset deal.
- Buyer purchase contingent on five employees accepting job offers. Brief revolt as 5 of 6 wanted more money. Settled for small amounts.

# Topic 3: Trade Secrets, No Patent, Know How Due Diligence – Bio Tech Firm

- Bio tech firm making diagnostic products. \$4 million in revenue. No profits. NIH entrepreneurs. \$12 MM stock deal.
- Seller licensed part of its technology from a larger int'l industry player under contract, but contract had to be re-set.
- Other technology under patent, but protocols for the manufacturing process were partly “in the heads” of scientists.
- Buyer had to get license renewed, and seller needed scientists “shadowed” by second person so protocols could be properly documented.

# Due Diligence with Respect to Vendors, Customers, and Employees

# Due Diligence – Sellers

- Do your own due diligence first
  - Know what you are selling
  - No surprises

# Due Diligence – Non-Disclosure Agreement (NDA)

- Who is covered? Make sure to include affiliates, consultants, and related parties
- “Confidential Information” definition
- How will Confidential Information be identified?
  - Marked materials vs. general definition
  - Consider standard carve-outs for publicly available information
- Reasonable period
  - Make sure Trade Secrets are carved out

# Due Diligence

- When to allow access to customers, vendors, and employees
- Consider access controlled data rooms and other tools
- How you will explain due diligence internally and externally

# Topic 4: Due Diligence – IP – Software Company

- Software firm ( \$22 MM revenue) to be sold to larger company. Proprietary software to process fin transactions.
- Neither “business process” nor “software” was patented. Mgt hadn’t thought to do it, or worried about theft.
- Buyer’s legal due diligence uncovered patent troll with expansive patent, and troll suing three firms for violations. Buyer thought a remote, but possible exposure here.
- Transaction held up for four months as buyer researched the situation, and felt protected.

# Topic 4: NDAs – Protecting Customer, Vendor Data – Typical Sequence

- Who usually signs NDAs in M&A sale process?
  - VC's NO
  - Strategic buyers YES
  - Buyout funds YES
- NDAs are signed after buyer looks at 1-page 'teaser.'
- Conf. Info Memo. sent after NDA signed.
- Recent example: 254 candidates, 56 NDAs, 8 offers; but 10 buyer candidates couldn't agree on NDA. Int'l candidates were OK with NDA's, but EM's an issue.

# Questions?