

# Pressure Points When Negotiating Executive Employment Agreements

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## About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits
  
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

## Upcoming 2024 Webinars

- 2024 webinars:
  - International Employees: Is a Global Employment Company a Solution (3/14/24)
  - Partnerships & LLCs: Solutions to Underwater Profits Interests Awards (4/11/24)
  - Comparing and Contrasting Equity Awards: A Life Cycle Approach (5/9/24)
  - Navigating Employee v. Independent Contractor Classifications (6/13/24)
  - ABCs of Private Company ESOP Transactions (7/11/24)
  - Compensatory Thoughts on Navigating Blackout Periods (8/8/24)
  - Preparing for Proxy Season: Start Now (Annual Program) (9/12/24)
  - Governance: Properly Hiring and Terminating an Executive Officer (10/10/24)
  - Introduction Course on Employment Taxes (11/14/24)
  - What Happened in 2024: Year-End Review of Compensatory Items(12/12/24)

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## Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources
  
- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

## Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



# Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

## Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

## Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

## Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

## Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

## Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

## International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy



## Introduction – Compensatory Elements

- The purpose of this presentation is to discuss the various provisions of a fully robust executive contract, and then to highlight where the design points reside for increasing value, discussed from both an employer and employee perspective
  
- To that end, the compensatory elements are:
  - Base salary;
  - Annual cash bonuses;
  - Long-term equity or incentive awards;
  - Severance pay;
  - Perquisites;
  - Employee benefits;
  - 280G golden parachutes; and
  - Restrictive covenants such as non-competes, non-solicitations, confidentiality provisions, inventions assignments, and waivers and releases

## Introduction - ISS & Problematic Pay Practices

- There are numerous problematic pay practices that ISS will evaluate on a case-by-case basis to determine whether such are contrary to a performance-based pay philosophy, including:
  - Multi-year guarantees of pay,
  - Excessive new-hire packages,
  - Incentives that motivate excessive risk-taking (discussed on next slide),
  - Abnormally large bonus payouts without performance linkage or proper disclosure,
  - Egregious pension/supplemental executive retirement plan payouts,
  - Excessive or extraordinary perquisites,
  - Excessive severance and/or change-in-control provisions (*e.g.*, single triggers, new or materially amended agreements containing excise tax gross-ups, etc.),
  - Excessive reimbursement of income taxes,
  - Dividends or dividend equivalents paid on unvested performance shares or units,
  - Internal pay disparity (*i.e.*, excessive differential between CEO total pay and that of the next highest paid NEO), and
  - Repricings without prior shareholder approval

- Additionally, there are certain problematic pay practices that are deemed “significant,” the presence of which will likely result in an adverse recommendation from ISS, such being:
  - Repricing without shareholder approval,
  - Excessive perquisites or tax gross-ups,
  - New or extended executive agreements that provide for:
    - Change-in-control payments exceeding 3x base + average/target/most recent bonus,
    - Single trigger or modified single trigger change-in-control severance payments without a substantial diminution of duties,
    - Excise tax gross-ups for change-in-control payments,
    - “Good Reason” termination definitions that are not conducive to an adverse constructive discharge theory and present windfall risk. [Note: Definitions that are triggered by the failure of an acquiring entity to assume the agreement in question no longer trigger the problematic pay practices policy.]
    - Multi-year guaranteed awards or increases that are not at risk due to rigorous performance conditions, and
    - Liberal change-in-control definition combined with any single trigger change-in-control benefits
  - Insufficient executive compensation disclosure by externally-managed issuers, such that a reasonable assessment of the pay programs and practices for such externally-managed issuers is not possible
  - Severance payments made when termination is not clearly disclosed as involuntary,
  - Any other provision or practice deemed to be egregious and presents a significant risk to investors

- The following are examples of incentives that could motivate excessive risk-taking:
  - A single or common performance metric used for both short-term and long-term plans,
  - Multi-year guaranteed bonuses,
  - Mega annual grants providing unlimited upside and no downside risk, and
  - High pay opportunities relative to industry peers
  
- ISS acknowledges that risky incentives can be mitigated with rigorous clawback provisions and robust stock ownership/holding guidelines
  
- Front-loaded awards
  - ISS is unlikely to support front-loaded awards that are intended to replace grants covering more than 4 future years (*i.e.*, the grant year plus three future years)
  - With respect to front-loaded awards of 4 years or less, ISS requires the issuer to make a firm commitment to not grant additional awards over the covered period

## Pre-Negotiation Considerations

- Who is the proper party to negotiate the business points on behalf of the Company?
  - The Board of Directors (or its delegatee),
  - The Compensation Committee of the Board of Directors (or its delegatee),
  - The CEO or another officer, or
  - In-house legal counsel
  
- Consider utilizing a term sheet structure to negotiate business points (instead of negotiating business points from the draft employment agreement), that would later be integrated into an offer letter or employment agreement?
  
- Should the Company perform a benchmarking analysis to determine “how much” and “what type” of compensation should be offered?

## Pre-Negotiation Considerations (cont.)

- Structure the negotiation in a way that preserves the “business judgment rule” defense for the Board
- If the business judgment rule is applied:
  - Then the decisions of a Director will be presumed to have been informed, made in good faith, and accomplished with the belief that such was in the best interests of the Company; the presumption makes it more difficult for a plaintiff to prove such Director breached his/her fiduciary duties
- Tally sheets
  - Tally sheets can be instrumental to preserving the business judgment rule defense because tally sheets can be used to help prove that the directors made an “informed” decision
  - A tally sheet lists each component of an executive’s compensation and tallies it up (*a.k.a.*, a “placemat”)
  - The Compensation Committee should require the use of a tally sheet when negotiating with executive officers
  - Tally sheets should be attached to the minutes
- Amounts to tally
  - Income for the year
  - Projected values under different performance and termination scenarios
  - Potential realized option and stock gains
  - Potential total wealth accumulation

## Pre-Negotiation Considerations (cont.)

- In contrast, pre-negotiation considerations for Executive generally relate to:
  - Maximize capital gains tax over ordinary income tax,
  - Defer income (if desired),
  - Protect Executive's economic position upon consummation of a change in control,
  - Provide Executive with upside if the Company's value appreciates,
  - Minimize exposure to possible additional/excise taxes under Sections 409A and 280G of the Internal Revenue Code of 1986, as amended, and
  - Help avoid or mitigate the 6-month wait rule under Section 409A (if desired)

## Duties and Exclusive Services

- Addressing the section entitled “Duties”
  - This is a key provision on when or if:
    - The executive can later terminate for Good Reason and receive severance pay, or
    - The company later seeks to terminate the executive’s employment for Cause
  - The purpose of this provision is to address the executive’s title, reporting responsibilities and job description duties
  - The company has the greatest flexibility if the Duties section is drafted generically (as opposed to highly specific duties), thus providing the company with flexibility if in the future the executive’s duties need to change
    - Retaining flexibility in favor of the company is particularly important if the employment agreement contains a Good Reason trigger for termination of employment
  
- Addressing “Exclusive Services”
  - The purpose of this provision is to contractually require Executive to devote his/her full working time to the company
  - To the extent outside activities are permitted (e.g., serving on another entity’s board of directors), consider:
    - Requiring advance approval from the Board and/or placing a numerical limit on the quantity or type of outside activities; or
    - Specifically identifying any permitted outside activities within this section or by attaching an Exhibit



## Term of Employment

- The purpose of this provision is to address the date on which the contract will expire, e.g., “. . . upon the earlier of: (i) the 3<sup>rd</sup> anniversary of the Effective Date and (ii) the termination of Executive’s employment under this Agreement.”
  - The “3<sup>rd</sup> anniversary” is an example of a natural expiration of the contract, which generally dictates that no severance pay would be owed under the contract
  - If restrictive covenants are covered by the contract, then verify that such survive any termination of the contract, including an expiration of the contract (*i.e.*, the survival section is typically contained within the Miscellaneous provisions near the end of the contract)
  
- Consider whether to add an “evergreen” provision that requires the contract term to be automatically extended for an additional [1] year periods unless prior written notice is provided within [90] days prior to the expiration of the term
  - Sometimes the amount of severance will be linked to the remaining term of the contract, including the remaining term with any evergreen. If such is the case, limiting the evergreen to one year terms is desirable from the Company’s perspective

# Compensation

- Base salary
  - It is good practice to indicate “when” Base Salary will be reviewed by the Board
  - Goal is to avoid off-cycle attempts by Executive to renegotiate his/her Base Salary
  - If Executive requires a provision that prohibits a reduction of Base Salary, then consider adding a carve-out that would allow for reductions to the extent they are proportionate to employee-wide or executive-wide cutbacks
  
- Bonus
  - Generally, contracts offer Executive with a bonus, even though the timing and the amount of any bonus might be subject to the sole discretion of the Board
  - It is also common to set a target bonus equal to a % of Executive’s Base Salary
  - Be sure any provisions addressing the timing of a bonus payout comply with Section 409A
  
- Signing bonus
  - Signing bonuses are typically provided in the form of cash or equity
  - If a signing bonus is provided, then determine whether the signing bonus should be forfeited or subject to clawback if Executive terminates employment within a certain period of time or attempts to violate any provision of the contract

## Compensation (cont.)

- Equity grants
  - Indicate when the grant is to occur (to avoid sloppy grant practices and potential allegations of back-dating)
  - Is it to occur in the future when the Board acts? Or is it to occur on the Effective Date of the contract?
  - If the latter, ensure that the Board approves the contract because, absent a valid delegation of authority from the Board to another individual or committee, only the Board has the authority to grant equity
  - Consider whether key terms of the equity grant should be included within the contract, such as number of shares, strike price (if any), vesting schedule, any restrictive covenants, etc.
    - Alternatively, have the key terms attached as an Exhibit and ensure the merger clause of the executive contract incorporates the Exhibit
  
- Inducement grants (publicly-traded company issue)
  - For companies with a limited share reserve under their equity incentive plan, consider using an inducement grant
  - Inducement grants can be provided outside of the Company's stockholder-approved equity incentive plan
  - Inducement grants are an exception to the stockholder approval requirements under NYSE and NASDAQ listing rules

## Compensation (cont.)

- Benefits
  - Absent a start-up company situation, Executive would likely be entitled to participate in welfare plans and retirement plans sponsored by the Company
  - Executive should ascertain whether highly compensated employees of the Company are able to FULLY participate in the 401(k)
    - Otherwise, consider adopting a non-qualified deferred compensation plan or arrangement for the benefit of Executive
  
- Expense reimbursement
  - Typically reimbursement will be subject to the Company's reimbursement policies and procedures
  
- Fringe benefits
  - From the Company's perspective, and to allow for Company-wide future policy changes without Executive consent, it is best to list as few fringe benefits within the contract as possible
  - Examples of fringe benefits include: (i) first class air travel, (ii) relocation assistance, (iii) financial planning assistance, (iv) business club memberships, (v) golf memberships, (vi) car allowance, etc.

## Compensation (cont.)

- Perk - Car allowance
  - Providing a dollar allowance is the cleanest
  - However, if instead a lease is to be provided, then consider who is responsible for the lease if Executive terminates prior to the end of the lease term? Who has the first opportunity to purchase the car from the lease?
  
- Perk - Relocation assistance
  - Reasonable costs of relocation are often covered. How is this defined? Does it cover sale of the prior home, a house hunting trip, broker fees/commissions, the whole family, the number of trips, etc.?
  
- Perk - Legal fees
  - Depending on the position, it is customary to cover legal fees incurred by Executive in conjunction with the review and negotiation of the contract

## Equity Awards – Net Withholding v. Open Market Sales

- Advantages of net withholding provisions (compared to open market sales) include:
  - Assuming the equity plan document contains liberal share counting, the life expectancy of the share reserve should be longer because a lesser number of shares are actually issued;
  - Reduced shareholder dilution because only the net shares are considered issued and outstanding;
  - The holder receives the same economic benefit as a broker-assisted sale in the open market;
  - Broker fees are avoided;
  - Avoids blackout periods since there is no open market transaction (though check insider trading policy to ensure permissible during blackout period); and
  - More favorable treatment in calculating basic earnings per share
  
- Disadvantages of net withholding provisions (compared to open market sales) include:
  - Decreased cash flow for the company because the company has to remit its cash to the U.S. Treasury to satisfy the withholding obligation, and
  - ISS may assign a higher cost to the awards

## Indemnification

- Generally, indemnification of executive officers and members of the board of directors is addressed in the articles of incorporation and bylaws of the Company
  - Therefore, it is preferable from the Company's perspective to NOT include such a provision within the employment agreement
  - But to the extent such a provision is provided in the employment agreement, care needs to be taken to ensure such a provision is not outside the scope of the indemnification otherwise contained within the articles of incorporation and/or bylaws
  
- Same issue applies in the context of an errors and omissions policy

## Employment Termination Triggers – Cause

- A typical definition of “cause” includes:
  - A material breach by the executive of his or her obligations under the agreement,
  - A willful or continued failure to follow orders or perform,
  - A conviction or plea or nolo contendere to any felony or a crime involving dishonesty or moral turpitude or which could reflect poorly on the company,
  - An executive engaging in misconduct, negligence, etc., that is injurious to the company,
  - A material breach by the executive of a written policy of the company, and
  - Any other misconduct by the executive that is injurious to the financial condition of the company and/or its reputation
  
- Should a notice and cure period be provided?
  - See explanation under Good Reason
  
- In the new hire situation, modifiers to the above are typically negotiated (e.g., materiality, continued, etc.)



## Employment Termination Triggers – Cause (cont.)

- [Cause, continued from prior slide]
- Consider defining the term “cause” to include a substantial under-performance (e.g., failure to achieve minimum financial goals for two consecutive fiscal years)
  - Such a provision is not typical and would subject the executive to elements that could be outside his or her control
  - A similar provision that is more veiled could include: (i) the executive failed to comply with the expectations of the company or (ii) the executive failed to follow the directions of the Board
- Consider adding an after-acquired evidence clause to allow the Board, after a termination of the executive’s employment without Cause, to retroactively re-characterize such termination as a termination for Cause. Otherwise, evidence supporting a termination for Cause that is found after the executive’s termination would not likely be used to retroactively re-characterize the executive’s termination (thus, a payout of severance benefits would likely continue)
  - And from the executive’s perspective, if an after-acquired evidence clause is used, then add language to provide that any such use of an after-acquired evidence clause would negate any previously executed waiver and release that was previously signed near the time of the executive’s termination of employment

## Employment Termination Triggers – Good Reason

- A typical definition of Good Reason includes:
  - A material diminution in the executive’s base salary or failure by the company to pay material compensation when due;
  - A material diminution in the nature or scope of the executive’s authority, duties, responsibilities or title from those applicable to him as of the Effective Date of this Agreement;
  - The company requiring the executive to be based at any office or location more than [ ] miles from [ ];
  - A material breach by the company of any term or provision of this Agreement; or
  - An acquiror in a change-in-control transaction failing to assume this Agreement
  
- It is favorable to the company to require both a notice and cure period before Good Reason can be triggered
  - Consider that if a notice and cure period is used in Good Reason, is it fair to also apply a mirror notice and cure provision to the definition of Cause
  
- Should there also be a claims run out period, such that if Good Reason exists, the executive must provide notice within [ ] days of such initial existence, otherwise, the claim giving rise to Good Reason is considered waived by the executive
  - The purpose of such a provision is to prevent the executive from “saving” the Good Reason trigger for a rainy day 6 months or a year after-the-fact
  - Consider whether Cause should contain a mirror provision

## Structuring Severance Pay

- Generally, severance pay is only contractually provided if the executive is terminated by the company for Cause or by the executive for Good Reason
  - Severance pay includes accelerated vesting of equity awards
- Consider that severance pay should be “bridge pay” (*i.e.*, a bridge between jobs)
  - Consider whether it makes sense to offset the amount of any future severance pay by the amount of any income the executive earns from his or her new employer, if applicable

## Structuring Severance Pay (cont.)

- Should severance be a multiple of base salary? A multiple of base and bonus?
- Should severance wear-away over time as the executive builds internal wealth due to equity awards and his or her beneficial interest in the Company?
- Should severance pay be higher in change-in-control situations?
  - What is the policy reason?
- Should severance pay be provided in any of the following situations?
  - Disability
  - Death
  - A failure by the Company to renew the employment agreement

## Structuring Severance Pay (cont.)

- Consider designing severance pay in the form of salary continuation (as opposed to lump sum payout)
  - Such allows the Board to hold the “purse strings” necessary to enforce any post-employment restrictive covenants such as non-competes, non-disparagement clauses, etc.
  - Should salary continuation stop to the extent the executive found a replacement job?
  
- Require that the executive execute a waiver and release of all known and unknown claims as a condition precedent to receiving severance pay
  - A form of such release should be attached to the executive contract as an exhibit (*i.e.*, “. . . , substantially in the form attached hereto as Exhibit A.”)

## Structuring Severance Pay (cont.)

- Should severance pay in the change-in-control situation be double trigger or single trigger?
  - Single trigger = change-in-control alone triggers payout
  - Double trigger = change-in-control and a termination of employment for Good Reason or without Cause is required
    - A related thought is whether there should be a post-change-in-control protection period? Idea being that after a certain amount of time (e.g., 1 year), any termination is likely the result of the executive and less the result of the change-in-control, and so related severance protection should end abruptly or phase out over time

## Waiver and Release

- It is common practice to require the executive to timely execute, as a condition precedent to any accelerated vesting or separation pay, a waiver and release of all known and unknown claims
- Consider attaching the form waiver and release, “substantially in the form attached hereto,” so as to avoid future issues at the time of an employment termination event

## Address 280G Mitigation Techniques

- Golden parachute payments are governed by Section 280G and 4999 of the Code. If applicable, these Code sections generally:
  - Impose a 20% excise tax on disqualified individuals for their receipt of an excess parachute payment, and
  - Deny a corporate deduction for the same
- Only “excess” (amounts exceeding 2.99x the “base amount”) “parachute payments” that are “contingent” on a CIC that are paid to a “disqualified individual” are subject to adverse tax consequences under 280G
  - Negate any of these 4 elements and 280G would not apply to that particular payment
- Once the above adverse tax consequences are triggered, the 20% excise tax (and the corresponding disallowed deduction) applies to parachute payments that exceed 1x the base amount



## Mitigation Alternatives

- Alternative No. 1 – Do nothing
  - Deduction would be disallowed and the disqualified individual would be subject to an excise tax
  
- Alternative No. 2 – Allow the payment but provide the disqualified individual with protection through a full or partial gross-up
  - Not a favorable design with ISS and certain other institutional shareholders
  
- Alternative No. 3 – Implement a cutback so that the parachute payment would not exceed 2.99x base amount (*i.e.*, the threshold test is NEVER satisfied)
  - May not be ideal for a disqualified individual who could be financially better off paying the excise tax (instance where payment would otherwise equal, for example, 7x base amount)
  - Conversely, a cutback could be financially advantageous to a disqualified individual if the payment exceeding 2.99x base amount would otherwise be less than the amount of the excise tax (instance where payment would otherwise equal, for example, 3x base amount)
    - Remember, the excise tax applies to amounts exceeding 1x base amount

## Mitigation Alternatives (cont.)

- Alternative No. 4 – Implement a hybrid cutback whereby a disqualified individual would be entitled to receive the greater of a 2.99x cutback or payment of the excess parachute payment with the 20% excise tax
  - This is also known as a “net better” provision
- Alternative No. 5 – Same as Alternative No. 4, but apply a cap so that if the payment triggers a 20% excise tax, that such payment will not exceed a certain dollar amount (thus artificially limiting the amount of the exposure)
- Alternative No. 6 – Implement a stockholder vote exception (only applicable to privately-held corporations), which generally means:
  - The disqualified individual irrevocably waives his/her right to the parachute payment that exceeds 2.99x his/her base amount,
  - Irrespective of the waiver, the payment is approved in a separate vote of the stockholders that is approved by more than 75% of the outstanding voting power,
  - Adequate disclosure to the stockholders must be made of all material facts,
  - The vote must establish the right of the disqualified individual to receive the payment
- Alternative No. 7 – Same as Alternative 6, but provide a gross-up if the corporation fails to seek stockholder approval
  - However, it is important to note that due to the full disclaimer requirement under the shareholder vote exception, the foregoing cannot be applied to the condition of gaining stockholder approval

## Non-Disparagement Provisions

- Means that one party will not disparage the other party
  - The provision is typically enforced by the Company against Executive by the former holding the “purse strings” of severance pay (*i.e.*, breach of the provision by Executive would stop the flow of severance pay from the Company to Executive)
  
- Executives typically seek a mutual non-disparagement clause
  - However, such can be problematic for the company because the Company cannot affirmatively control its employees
  
- A solution is to:
  - Limit the non-disparagement clause to bind Executive’s actions
  - Then the Company could provide Executive with a limited non-disparagement clause that would essentially require the Company to instruct its Board members, executive team and senior management, to not say anything disparaging about Executive

## Other Terms

- Ensure that the definition of “change in control” within applicable arrangements requires *consummation* of the transaction
  - There are a few public examples where payouts to executives were triggered upon signing the underlying transaction document even though the transaction was never consummated
- Require Executive’s automatic resignation from the Board and all committees upon his or her termination of employment
- Include a survivability provision so that payment terms and restrictive covenants, for example, survive the termination of the executive contract
- Consider whether to contractually toll the non-compete provision for any period of time Executive violates the restrictive covenant
  - Some states do not insert equitable tolling as a matter of law, and therefore would not otherwise toll the non-compete beyond the express terms of the contract
  - Absent equitable tolling or a contractual tolling provision, it may be difficult for an employer to enforce, for example, a six-month non-compete provision (*i.e.*, it could take more than six months to get to court)
- Be sure to address Dodd-Frank clawback provisions

## Don't Forget Next Month's Webinar

- Title:
  - International Employees: Is a Global Employment Company a Solution
  
- When:
  - 10:00 am to 11:00 am Central
  - March 14, 2024