

Employment at Will
Employment Agreements
Employee Handbooks and Manuals
Restrictive and Proprietary Covenants
Employer's Right to Employee Work Product
Trade Secret Protection
Covenants Not to Compete
Incentive Compensation Plans
Deferred Compensation
Pension and Profit Sharing Plans
Incentive Stock Options
Life Insurance Programs
Employee Expense Reimbursement Plans

EMPLOYMENT AND COMPENSATION

The first chapter discusses the principles of agency. These rules are the foundation of the operations of a business enterprise. Sole proprietors must hire employees and agents to perform duties in the business if they want help in their daily operations. Partners are agents for their partnership and for the other partners. A limited liability company may employ managers and other agents to administer its affairs. In a corporation, the business acts only through directors and officers, who are agents of the corporation. Agency is the underlying basis for most of the internal legal relationships of an enterprise.

The agency rules can apply to any situation in which a person authorizes another to perform a task. In a business organization, those tasks usually relate to the operations of the business, such as performing the duties of a cashier or truck driver or acting as the attorney or accountant for the business.

Because of the significant obligations created under agency law, all business relationships that involve an agent should be reduced to writing and clearly defined so that the obligations and rights of the principal and the agent can be clearly understood and interpreted. Within a business organization, employees are agents and their duties and rights are generally based upon the principles of agency law. Most of these rules may be defined and supplemented by agreements, and both the employer and the employee generally desire a clear understanding concerning the nature of the employment, the duties to be performed, and the compensation and benefits to which the employee will be entitled. Other issues also may be addressed in employment agreements to clearly define the rights and responsibilities of the agent and the principal.

A corporation offers the most flexible employment and compensation possibilities of any form of business. Managerial talent may be widely distributed in the corporate structure, from directors and officers to other management executives and supervisory personnel, and the compensation schemes are equally varied, particularly because of the many tax advantages available through the corporate entity. However, much of what is said here also applies to employees of proprietorships, partnerships, and limited liability companies whose business structures approach the complexity of a corporation and whose employees may be entitled to similar compensation and tax-advantaged incentive programs.

Most employees are hired on an informal basis, without any written contract, and they perform duties for a stated compensation, in salary or wages, until their employment is terminated. Certain personal motives may induce the employee's performance and provide compensatory incentives. The company may be a family business, and the employee, as a member of the family, may have a kindred incentive to do the job well. The employee may be a shareholder and, therefore, have a pecuniary interest in his or her own performance; if the employee's performance contributes to business successes, the employee's stock becomes more valuable. These informal employee relationships do not require much planning or counsel and, because of their simplicity, are appropriate arrangements for most proprietorships and many partnerships, limited liability companies, and corporations. However, they do not take advantage of the special methods of preserving talent and compensation available through more elaborate employment agreements.

These traditionally informal employment arrangements have become more complicated through various state and federal laws that have been enacted to protect employees' rights and to ensure fairness in hiring and firing practices.

EMPLOYMENT AT WILL

As a matter of contract law in most states, employees are presumed to be employed as **employees at will** unless they have agreements that they will be employed for a specified term or may be terminated only for specified causes.¹ At-will employees are not employed for any set period of time. They may resign or their employer may fire them at any time, with or without cause and without advance notice, procedures, or formality.

There are a few exceptions to the freedom employers generally enjoy regarding at-will employees. Employers may not terminate employees, including at-will employees, as a result of illegal discrimination. In addition, certain large employers must give advance notice before laying off a significant number of workers.²

Prohibited Employment Discrimination and Required Conduct

There are several areas in which employers must comply with federal equal employment laws and regulations, including many areas for which it is wise to have personnel policies. Employers must comply with equal employment opportunity laws and may not discriminate against applicants or employees based on: race, color, religion, sex, or national origin under Title VII of the Civil Rights Act of 1964³ and the Equal Pay Act of 1963⁴; age (employees 40 or more years old under the Age Discrimination in Employment Act);⁵ or disabilities under the Americans with Disabilities Act.⁶ Employers also may not engage in and should not tolerate sexual harassment or harassment based on an employee being, or perceived to be, a member of a protected class.⁷

Most private employers also must meet federal requirements for employee compensation (e.g., minimum wage, overtime, withholding and record-keeping⁸) and employee rights to leave of absence (for pregnancy,⁹ jury duty,¹⁰ military service,¹¹ and, for large employers, medical and family needs¹²).

Many states have employment discrimination laws that parallel the federal laws and impose additional restrictions and requirements, such as prohibiting discrimination based on marriage and requiring leaves for voting. An increasing number of local governments have nonsmoking ordinances employers must follow. Many jurisdictions prohibit discrimination based on employees' sexual preference.

To help avoid or minimize problems, employers are well advised both to avoid the prohibited discrimination considered above and to have personnel policies about at-will employment, equal employment, pay, overtime, leaves, harassment, and sexual harassment. The personnel policies may be stated in an employee manual (discussed later in this chapter) or simply used as guidelines that are followed by the persons responsible for human resource problems in the company. In addition, all employers must post notices in a conspicuous place about

- equal employment (federal and state antidiscrimination laws)
- minimum wage

- overtime
- child labor
- job safety
- workers' compensation
- unemployment insurance benefits
- protection from lie detector tests
- smoking

Depending on their size and business, employers must also post other notices or distribute policies. For instance, companies with more than 50 employees must post notices about leaves under the Family and Medical Leave Act, and certain industries, such as those that employ interstate drivers or whose workers may be exposed to hazardous materials, are required to have notices and policies about drug screening and testing or hazardous materials.

Employee Records

Employers must comply with certain laws and keep records of their compliance with the laws covering the following areas:

- immigration (Form I-9 and proof of each employee's citizenship)
- wages and overtime (payroll and employee identification data; hours all nonexempt employees worked; pay and means of pay calculation, including all additions or deductions and the value of any nonmonetary compensation; and documents describing any benefit and premium payments for employee benefits)
- leave (leave notices, employer leave policies)
- personnel records (job advertisements; employment applications; records regarding hiring, employment agreements, training, testing, promotion, demotion, or transfer; total employee count for each month, states of residency and states where they worked for the employer; performance evaluations; any disciplinary action taken or considered; any employee disputes; any harassment or sexual harassment complaint or discrimination charge or action, investigation and result; layoffs or termination, including all reasons for separation; references received and given; and any medical certifications or records, which must be kept in separate, confidential files)

The time such records must be kept varies. The maximum requirement applies to wages and personnel information, for which employers must preserve records for five years.

Wages and Overtime

Any business with gross annual sales or business totaling \$500,000 or more or that has two or more employees who engage in interstate commerce is covered by the federal Fair Labor Standards Act (the "FLSA"). The FLSA and many similar state or local wage laws specify that employers must pay a minimum wage. Wages must be paid in cash or its equivalent; employees cannot be paid in merchandise, products, or other coupons or paper that allows employees to purchase products from the employer. Employees must be paid at least monthly and employees earning hourly wages must be paid within ten days after the end of a pay period.

Most federal and state employee laws distinguish between exempt employees and nonexempt employees in describing the mandatory pay and benefits to which employees are entitled.

Exempt employees are paid according to their salary and are not entitled to overtime payments. These persons are professional and managerial personnel who are expected (and paid) to work until they have accomplished the tasks that have been assigned to them. **Nonexempt employees** are entitled to be paid overtime for all hours worked over forty hours in any work week, which is typically defined as a set period of seven consecutive days. Overtime is usually paid at 1 1/2 times each nonexempt employee's regular rate of pay. *Pay* for overtime purposes includes all remuneration nonexempt employees receive for their labor. "Pay" does not include compensation through retirement or profit-sharing plans, bonuses that are entirely discretionary, travel or other expense reimbursement, holiday pay or occasional gifts such as on holidays that are not related to hours worked, or compensation based upon production or efficiency. Under

most current laws, employers may not provide nonexempt employees with time off or **comp time** to avoid paying overtime.

Workers' Compensation and Unemployment Insurance Compensation

All states have workers' compensation insurance to cover employees' work-related injuries. This type of insurance is mandatory and, provided it is in force when an accident occurs, is the exclusive remedy for employees who are injured on the job.

Unemployment insurance is also created and governed by the laws of the state in which employees perform services for their employers. In general, employees who are terminated involuntarily are eligible for unemployment insurance benefits. Many unemployment insurance schemes disqualify employees whose terminations are "for cause," provided the reason for termination corresponds with any reason on a list of serious misconduct (such as theft, violence, gross insubordination, or continued unexcused absences from work).

Employers should verify the workers' compensation and unemployment insurance requirements of each state in which they have employees. Typically, employers must register with state offices that administer these benefits and obtain required levels of coverage from state insurance funds or approved private insurers.

Disadvantages of Employee at Will Status

Employee at will status gives the employee the right to stop working at any time and gives the employer the right to terminate employment at any time. In addition to the uncertainty caused by spontaneity of the relationship, there are employment benefits that an employee might desire from his or her employment. Unless employers commit to any of the following through an express contract, or through their words or conduct that form a promise or create an implied contract, there is generally no legal requirement to provide any of the following:

- pay for time not worked, including severance pay, paid vacations, holidays, or sick leave (except that some jury duty must be paid);
- holidays or vacation (except earned vacation time);
- rest periods (with some exceptions for certain hazardous jobs);
- limits on the work time or hours worked, such as involuntary overtime, weekend, holiday, or night work;
- pay raises or bonuses;
- premium pay for weekends or holidays;
- benefits (other than unemployment and workers' compensation);
- advance notice or reasons for termination, layoffs, or schedule changes (except large employers must give layoff notices); or
- access to personnel records.

As the company structure becomes larger and more employees are needed, managerial talent becomes more important. **Key employees** become an integral part of the organization, and their compensation and incentives assume greater significance. The company must ensure that these people will remain employees in order to guarantee a smooth reliable business organization. Key employees are not necessarily executives. They include salespersons, research and development personnel, and any other employees with special skills. The objectives of the company in retaining these people are selfish on two counts: first, with a loss of key employees, the business may suffer mild to serious reversals until they are replaced; and second, if key employees decide to work for the corporation's competitors, the company not only loses valuable talent but also risks the loss of important trade secrets and processes.

The employees also have some stake in their employment arrangements. There is a question of job security, advancement, and compensation. These complementary objectives of a continuing employment relationship may be satisfied through many combinations of employee agreements, incentive compensation plans, and fringe benefits.

EMPLOYMENT AGREEMENTS

An employee's job security objectives may be ensured by an **employment agreement** or **contract** in which the company promises to keep the employee employed for a period of time and the employee promises to perform the specified duties diligently for the specified period. Employment contracts provide considerably greater protection for the employee than for the employer, in part because courts generally refuse to force a person to perform against that person's will. Consequently, if the employee quits before the expiration of the employment term, the employer cannot successfully petition a court to order the employee to continue working involuntarily. On the other hand, if the employer fires the employee before the expiration of the agreement, the employee may recover the compensation he or she would have received had he or she been allowed to perform the agreement, unless the employer can prove good cause for termination. Nevertheless, an employer may gain some benefits from the employment contract insofar as the contract's terms prescribe incentive compensation to encourage the faithful continued performance of the employee. Further, the agreement may include noncompetition clauses that prohibit the employee's entry into a competing business upon termination, or it may reserve to the company any developments or ideas discovered by the employee during employment.

Like the documents used in many other areas of the law of business organizations, employment contracts must be tailored to the particular needs of the parties. It would be unrealistic to attempt to cover every possibility, but there are certain general rules basic to each agreement. A typical employment agreement should contain clauses describing the employee's responsibilities and duties; provisions for compensation and reimbursement of expenses; a description of the duration of the agreement; provisions for termination of the agreement; and, in many cases, noncompetition clauses, death and disability clauses, and provisions for company rights to discovery and development during employment.

Employee Duties

The contractual language that details the duties and responsibilities of the employee always depends on the particular needs of the employer, the talent and position of the employee, and the needs of the business. The definition of duties is extremely important, considering the possibility of later disputes. Not only must the employee know what the employer expects, but the employer must have some definitive guidelines upon which to measure the employee's performance. If the employee is terminated involuntarily before the expiration of the term of the agreement, the employer must be prepared to show that the employee failed to perform the specified duties under the contract. If the duties described in the agreement are ambiguous or otherwise ill-defined, this proof may be impossible.

The description of duties for top-level management positions necessarily must be broad. It would be difficult to detail all the duties expected of a company executive, since this person is hired to run the business. A general statement of management duties is unavoidable here.

Duties of a Manager

The Manager shall well and faithfully serve the Employer in such capacity as aforesaid, and shall at all times devote his or her whole time, attention, and energies to the management, superintendence, and improvement of said business to the utmost of his or her ability, and shall do and perform all such services, acts, and things connected therewith as the Employer shall from time to time direct that are of a kind properly belonging to the duties of a Manager.

EXAMPLE

More specific provisions may be used for positions with definable boundaries. Consider the following example regarding the duties of a research chemist.

EXAMPLE**Duties and Inventions of a Research Chemist**

The Corporation hereby employs the Employee as a research chemist. The Employee's duties shall include the application of his or her skill and knowledge as a chemist toward devising new pharmaceutical products and improving existing formulas, processes, and methods employed by the Corporation. All inventions, discoveries, and improvements devised or discovered by the Employee while in the employ of the Corporation shall become and remain the sole and exclusive property of the Corporation, whether discovered during or after regular working hours.

A manager of a merchandising outlet could have duties prescribed as follows:

EXAMPLE**Duties of a Merchandising Outlet Manager**

The duties of the Manager shall be such as are assigned to him or her by the Company. Initially there shall be included among his or her duties and authority the selection of a stock of merchandise for this venture, schedule of purchases to be submitted and subject to advance approval by the Company, and copies of proposed orders to be submitted to the Company to be passed upon and approved. Selections for current replacements for stock and purchases for new season requirements shall likewise be made by the Manager subject to prior approval by and submission of orders to the Company, in the same manner as is above provided for the initial stock. The Manager shall also keep a perpetual inventory of merchandise on hand and take a monthly physical inventory. The Manager likewise shall have full authority to employ and discharge employees of the business, subject to approval of the Company. The Manager will refer all disputed claims, not allowed by him or her for adjustments or returns on complaints, to the Company. The duties and authority hereby conferred are subject to change at the pleasure of the Company.

In preparing a description of duties, the employer (or, in some cases, the employee) shall prepare a statement of job description that includes all the specific items the employee is expected to do as part of employment. The initial job description prepared by the employer or the employee may then be modified to include other items related to the types of specific duties the employee will perform for the employer. The list of duties should begin with the most specific duties anticipated, and the duties should become more general as the list grows longer. It is important to attempt to identify all potential duties the employee is expected to perform and to highlight technical duties that are unique to this particular employee. In addition, each description of duties must be tailored to the specific employee and to the position the employee will hold.

In representing the employer, it is advisable to include a phrase that permits additional duties to be assigned to the employee from time to time. For example, a duties clause may provide that the employee will perform certain duties and "all other matters connected therewith as the employer shall from time to time direct, and that are of a kind properly belonging to the duties of an employee of this type." Similarly, the duties clause may include a statement that says "the duties and authority hereby conferred are subject to change at the pleasure of the company." These catchall provisions are desirable from the employer's viewpoint in order to ensure that the talents of the employee may be directed to changing employment opportunities, and also to permit the employer to assign specific duties that may not have been contemplated at the time the agreement was negotiated, but which will better define a breach of the agreement should an employee fail to perform them.

Catchall provisions in a statement of duties work to the disadvantage of the employee, unless certain limits are placed upon them. On behalf of an employee, it would be important to provide that any additional duties assigned are to be "of a type that properly belongs to the duties of an employee in a particular position," or "reasonable duties." In this manner, the employee may avoid the assignment of duties that are not consistent with the overall employment

or the assignment of inappropriate or distasteful duties to force the employee to breach the agreement.

The duties clause of the employment agreement also may serve to restrict authority and responsibility of the employee. Any limitations on the scope of the employee's authority should be clearly defined. Remember that the business will be liable for any transactions the employee is authorized to undertake, and the principal source of an employee's authority is the description of the employee's duties in the employment agreement. The agreement may reserve certain decisions or transactions to employees at a higher level for organizational purposes. The duties clause may define territories, as in the case of sales personnel, or impose any other restrictions consistent with the employment relationship.

Limitations on Authority of District Manager

EXAMPLE

The District Manager shall possess no authority not herein expressly granted and is not authorized on behalf of the Company to make, alter, or discharge contracts or binders, except as may be directed in writing by the Company, nor to waive forfeitures, grant permits, guarantee in dividends, if any, name extra rates, extend the time of payment of any premium, waive payment in cash, or to write receipts except for first premiums, or make any endorsements on the policies of the Company, and shall receive no further remuneration for any service except as herein provided. It is expressly stipulated and agreed that the District Manager is not authorized to incur any indebtedness or liability in the name or in behalf of the Company for any advertising, office rent, clerk hire, or any other purposes whatsoever or to receive any moneys due or to become due the Company exclusive of the first premium, except as may be specifically directed by the Company, and the powers of the District Manager shall extend no farther than are herein expressly stated.

Restriction

EXAMPLE

The District Manager shall not make or permit to be made by any agent, any use of the radio or insert any advertisement respecting the Company in any paper, or other matter, magazine, newspaper, periodical, or other publication or issue any circular or paper referring to the Company without the written consent of the Company.

Reservation of Right to Reject Orders

EXAMPLE

No order shall be deemed binding upon the company until accepted by the company in its principal office in writing, and the company reserves the right to reject any order, or to cancel the same or any part thereof after acceptance, for credit or any other reason whatsoever deemed by the company to be sufficient.

Compensation

The **compensation** clauses of an employment contract deserve special attention. In the first place, any ambiguity here is certain to become a matter of dispute, since financial matters are of utmost concern to both parties to the agreement. Moreover, the compensation provisions of the contract offer the best opportunity for the employer to ensure continued faithful performance by the employee. Recall that courts are generally unwilling to force an employee to return to the job following a breach of an employment contract. Carefully planned incentive compensation provisions will motivate the employee to remain with the company. Finally, the compensation provisions may permit certain tax advantages for all parties, and these matters should be explored and explained to the client.

At this point the discussion is limited to basic compensation schemes, applicable to all types of business organizations, and to current incentive provisions that encourage immediate, rather

than long-term, performance. The exclusively corporate compensation schemes, such as stock options, and the long-term incentive provisions, such as deferred compensation and profit sharing, are discussed separately in later sections.

The most basic type of compensation for an employee is a **salary** arrangement, and contractual terms should specify at least the amount and frequency of payment.

EXAMPLE

Salary Compensation

In consideration of the service so to be performed, the Employer agrees to pay to the Employee the sum of \$100,000.00, payable in equal monthly installments for twelve consecutive months at the end of each month, until the termination of this agreement.

A **current incentive** may supplement the salary agreement to encourage diligent performance by the employee.

EXAMPLE

Current Incentive Compensation

The Employer shall pay to the Manager a salary of \$120,000.00 per annum, payable by monthly installments of \$10,000.00 on the tenth day of each month and shall also pay to the manager a commission of two percent per annum on the net profits of said business, such commission to be paid within ninety days after the year accounts have been certified by the accountants employed by the employer, whose certificate as to the amount of such net profits shall be conclusive.

A percentage compensation agreement, a **commission**, is probably the best current incentive provision. The rate of compensation is based directly upon the employee's own performance, and the commission technique is used most effectively when applied to individual activities. However, this scheme also may be used to compensate management or supervisory employees whose performance depends in part on the efforts of others they control. For management employees, the percentage is frequently based upon profits produced under their direction. A clause must be included to define profits for application of the percentage. Moreover, since a determination of profits usually is not made until the close of the business year, the employee usually is permitted to withdraw specified sums in advance for current living expenses until the employee's percentage share has been determined. Examples of provisions for executive compensation follow:

EXAMPLE

Executive Commission Compensation

The Company shall pay to the Manager as compensation for his or her services one-third of the net profits arising from the Chicago business.

EXAMPLE

Net Profits

In arriving at what shall be deemed the net profits arising from the Chicago business, the following items shall be paid out of the gross profits, viz.: the rents of the premises wherein the Chicago business shall be conducted and all repairs and alterations of the same, all taxes and payments for insurance, all salaries and wages of clerks and employees other than the Manager employed in or about the Chicago business, and all charges and expenses incurred in or about the same, all debts or other moneys that shall be payable on account of the Chicago business, the interest on the capital for the time being advanced by the Company, and all losses and damages incurred in or about the Chicago business.

Drawing Account

EXAMPLE

The Manager shall have the right to draw out for his or her own use the sum of \$7,500.00 per month on account of his or her salary. The balance of his or her one-third share in the net profits shall not be withdrawn by him or her until after the annual general account hereinafter mentioned shall have been made and signed.

Commission provisions for an individual employee's performance require a similar approach. However, instead of profit, the percentage is usually applied to sales obtained for the company by the employee, and that criterion creates another definitional problem. The sale of goods involves at least four transactional stages: the order is signed, the order is approved by the company, the goods are shipped, and the customer pays. One of these four stages, or some other reasonably ascertainable point, should be selected as the time the commission is earned. If any intermediate stage is selected, the company may further specify that the commission will be withdrawn or reduced if the customer fails to pay.

Compensation and Basis for Computing Commissions

EXAMPLE

In consideration of your services, we agree to pay you a commission of five percent on all sales during the term of your employment made to customers located in the territory covered by you. Such commissions shall be calculated on the net amount of sales, after deducting returns, allowances, freight charges, discounts, bad debts, and similar items, and shall be deemed to be earned and payable only as and when orders have been shipped and actually paid for by customers. The prepayment of commissions shall not be deemed to be a waiver of the foregoing provisions, and in all cases in which commissions have been paid in advance of payment by the customer, or where returns or allowances are subsequently made, such appropriate adjustment as may be necessary shall thereafter be made.

Drawing Account and Traveling Expenses

EXAMPLE

You shall be entitled to receive and we agree to pay you a drawing account of \$2,000.00 per week, which sum shall be applied against and deducted from commissions then or thereafter due you. You personally shall pay all traveling and other expenses incurred by you in connection with your employment.

To be effective, current incentive programs should be directly related to the performance of the employee or of the persons under the employee's supervision. The employee has no control over unrelated performance and thus has no opportunity (or incentive) to improve it.

Current incentive programs pose special drafting problems to ensure absolute clarity. In the foregoing examples, the percentages, time for payment, formula for determining the amount to which the percentage is applied, and application of draws against earned compensation are all well defined. Each of these items must be unambiguous if the compensation provisions are to be effective. Some additional suggestions may be helpful:

1. A date or periodic date should be specified for the payment of incentive compensation. For example, if the incentive compensation is computed on an annual basis, it should be specified that payment will be made on a specific date of the following year, or within a certain number of days from the close of the business year. The exact date permits the employee to plan the receipt of income, and allows the employer to plan cash flow.
2. If accounting terms are used, such as *net profit* or *net sales*, they should be defined in the agreement. Specific expense items should be named if they are to be deducted from gross profit to reach net profit, or from gross sales to reach net sales. Moreover, the provisions should define profit as before or after income taxes are deducted, whichever represents the agreement of the parties.
3. The person or persons who determine the base amount against which the percentage is applied should be named. If the company retains independent public accountants to audit its

records, the accountants should be specified as the persons who will make these determinations, and it is common practice to specify that their determination is to be based upon “generally accepted accounting principles.” However, keep in mind that generally accepted accounting principles are not well-defined rules, even for accountants. To avoid any disputes concerning computations in an employment agreement, it is preferable to provide that the amount will be determined “by the accountant then engaged by the company in the accountant’s sole and exclusive judgment, which will be a conclusive determination for all purposes.”

4. If the employee is permitted to **draw** against the incentive compensation, the agreement should cover the contingency that the draws may exceed the earned compensation. For example, suppose the manager is to receive one-third of the profits as determined at the end of the year, and the manager has drawn \$36,000 during the year. If the profits total \$99,000 when tallied, will the manager be required to repay the company \$3,000, or will that amount accrue to be applied against the following year’s profits, or will it be forgiven and deemed to be an expense of the company? The agreement should provide an answer.
5. If the incentive compensation is based upon periodic performance such as annual profits, the employee’s commencement and termination during the period should be considered. A relatively small number of employees are hired on the first day of the business year. (A few more may quit on the last day, however, considering that the arduous task of taking inventory may be looming in the immediate future.) Nevertheless, some formula must be inserted for the employee who has not worked for the entire period upon which incentive compensation is based. A formula for this purpose may be drafted on any reasonable basis. For example, the employee’s percentage may be applied to profit computed for the period of the year during which the employee actually worked. If the employee began working August 1, the actual profit would be computed from August 1 to December 31, and the percentage applied against that figure. Alternatively, the formula may specify a pro rata determination of profit for the entire year. Here, the entire year’s profit would be reduced to five-twelfths, the fraction of the year from August 1 to December 31, and the percentages would be applied to that amount. Finally, a separate special formula for years of commencement and termination may be stated, such as one-sixth of the profit for these years, or no profit percentage if the employee works for less than half of any year, and so forth.
6. If the incentive compensation is based upon an event, such as the sale of the employer’s products or services, the event that will cause the compensation to be payable should be specified. The event could be
 - (a) when the salesperson enters into the contract to provide products or services;
 - (b) when the company accepts the order;
 - (c) when the products are shipped or the services are performed; or
 - (d) when the company is paid by the customer.

All of these events are negotiable between the employee and the employer, but the applicable event should be clearly specified in the agreement.

Closely related to the percentage compensation is a **bonus plan** based upon minimum performance of the employee, or the employee’s division or department. The agreement may establish certain sums to be paid at a specified time following the close of the business year if the employee’s individual performance or the employee’s section of the organization produces results above a specified minimum. The bonus amounts may be periodically increased to reward continued performance. For example, the agreement with a manager of a retail store may provide that the manager shall receive a bonus of \$1,000 the first year that net profits before taxes from the store exceed \$10,000; \$2,000 the second consecutive year that profits exceed that amount; and \$3,000 the third and subsequent consecutive years that profits continue to exceed \$10,000. The drafting considerations detailed earlier are equally applicable here. The agreement should define net profit or any other selected criterion, should specify the person who will determine the base figures, should provide for termination during the year, and should specify a date the bonus will be paid.

The bonus plan may be limited to an incentive for continuous employment, without considering the specific performance of the employee. For example, the agreement may discourage voluntary termination during the year.

Compensation and Bonus

EXAMPLE

The Employee shall receive a weekly salary of \$1,000. In addition, the Company shall pay to the Employee at the end of each year of the term a year-end bonus of not less than \$10,000 (less withholding taxes, social security, and other required deductions); but no part of said bonus shall be payable if the Employee shall be in default under this agreement or shall not then be in the employ of the Company.

The compensation section of the employment agreement is also an appropriate place to describe incidental financial benefits, such as reimbursement for expenses, vacation pay, and so forth.

Expense Reimbursement

EXAMPLE

Employer shall also pay to the Salesperson his or her reasonable expenses of traveling, board and lodging, postage, and other expenses reasonably incurred by him or her as such Salesperson in or about the business of the Employer.

Vacations

EXAMPLE

The Employee shall be entitled to vacations with pay in accordance with the established practices of the Company now or hereafter in effect for supervisory personnel.

The foregoing compensation plans are common to most employment agreements. Continued faithful performance of the employee also may be reasonably ensured by use of the special compensation techniques discussed in subsequent sections.

Term of the Agreement

The duration of the employment agreement should be specific and, as a general rule, should be reasonably short for the company’s protection. If a continuing employment relationship is contemplated, it is far better to provide for options to renew the agreement than to leave the term indefinite.

The basic term of the agreement is always simple.

Duties and Term

EXAMPLE

The Employee agrees to give his or her undivided time and service in the employ of the Employer in such capacity as the Employer may direct, for the period of one year from and after the 1st day of December, 2005.

Renewal provisions may be drafted in one of three ways. First, the option to renew the agreement may be granted to the employer, with appropriate advance notice to the employee of the election to renew. Second, the option to renew may be vested with the employee, with appropriate advance notice to the employer of the election to renew. Third, the agreement may be automatically renewed for specified periods unless appropriate notice is given by either party to the other of the intention not to renew. The last provision is most common, and most adaptable to a continuing employment relationship.

EXAMPLE**Option to Renew**

Employee grants Employer the option to renew this contract for a period of two years upon all the terms and conditions herein contained, except for the option to renew for a further period. This option may be exercised by Employer by giving Employee notice in writing at least thirty days prior to the expiration hereof; and such notice to Employee may be given by delivery to Employee personally or by mailing to Employee at the last known address.

EXAMPLE**Initial Term and Automatic Renewal**

The term of this employment shall commence February 1, 2005, and shall continue for a period of two years until January 31, 2007, and thereafter shall be deemed to be renewed automatically, upon the same terms and conditions, for successive periods of one year each, until either party, at least thirty days prior to the expiration of the original term or of any extended term, shall give written notice to the other of intention not to renew such employment.

Provisions for notice should be tailored for specific circumstances. Written notice should always be required, and should be sent to a specified address of each party. For the employee, the address may be specified as “the last known address,” or “the address on the records of the company.” The time period for notice should be longer for a more specialized employee so that the employee may search for other employment if necessary, or so that the company may search for a replacement.

Termination of the Agreement

The employment agreement should be terminated or terminable upon the happening of certain contingent events. In many cases, salary continuation protection for an employee may be appropriate upon the happening of one of these events, and in cases where the event is also defined by an insurance policy, the employment agreement should use the definition from the insurance policy to be certain there is no conflict between the two definitions.

The following contingent events should be considered as potential causes for termination:

1. the employee is disabled for a period of time;
2. the employee is bankrupt;
3. the employee has been convicted of a crime;
4. the employee is incarcerated;
5. the employee is mentally disabled or otherwise unable to perform duties;
6. the employee is suffering from substance-abuse disabilities;
7. the employee breaches the agreement;
8. the portion of the business in which the employee is employed is discontinued for any reason;
9. the business is insolvent or bankrupt;
10. a substantial portion of the business assets are destroyed;
11. the business is sold, merged, or dissolved for any reason;
12. majority ownership of the business changes; or
13. any other matter arises that, considering the special duties of the employee, may constitute cause for termination under the agreement.

EXAMPLE**Termination of Manager with Cause**

In the event of the illness of the Manager or other cause incapacitating him or her from attending to his or her duties as manager for six consecutive weeks, the Employer may terminate this agreement without notice upon payment to the Manager of \$5,000.00 in addition to all arrears of salary and commission when ascertained up to the date of such termination. In the event of a breach of this agreement or of an act of bankruptcy on the part of the Manager, the Employer may terminate this agreement without notice or payment of salary or commission as hereinbefore provided.

Termination with Cause

EXAMPLE

This agreement shall terminate in the event of the dissolution of the firm by death or otherwise, the appointment of a receiver or trustee in bankruptcy or the filing of a petition to reorganize under the Bankruptcy Act, or the destruction by fire of the firm's warehouse at South Bend, Indiana, notwithstanding the full term of one year may not, at the happening of any of said events, have fully expired.

Finally, it is possible to agree to termination without cause with due notice.

Termination without Cause

EXAMPLE

The employment of the Employee may be terminated at any time (during the said period of two years) by either party giving to the other two calendar months' notice in writing of its or his or her intention to terminate the same, or by the Company upon its paying to the Employee a sum equal to two months' salary at the rate aforesaid in lieu of such notice.

Severance Compensation

Most current employment agreements for senior executives in business provide for **severance compensation** upon termination of the agreement, especially when the company chooses to terminate the agreement. When an employment agreement provides for the consequences of termination in terms of compensation to the terminated employee, the likelihood of litigation alleging wrongful termination is reduced (since agreement usually provides that receipt of the severance compensation is a release of any claims for wrongful termination) and the payments are regarded by both the employer and the employee as a form of agreed damages to compensate the employee for the difficulty and burden of looking for new employment. High-level managers are not freely marketable; they will require some time to find new positions that match their talents and meet their compensation requirements. Severance packages are customarily called "**golden parachutes**," and they provide for continuation of salary or lump sum payments of future expected salary, continuation of employee benefits for a period of time, and, in some cases, the repurchase of stock or ownership interests in the business owned by the executive.

The variations of golden parachute provisions are endless and depend entirely upon the executive's ability to negotiate his or her termination provisions upon accepting employment. Usually, the value of the severance package varies according to whether the company terminates the employee with or without cause or whether the employee elects to terminate the employment to leave for greener pastures. In some cases, the employee is entitled to severance payments if the employee elects to resign because his or her duties have substantially changed through a modification of company policies by the board of directors or through a transfer of the control of the business to another entity. The duration of the compensation and benefits often depends upon the employee's obligations under a covenant not to compete or similar employment restriction imposed by the employment agreement.

EMPLOYEE HANDBOOKS AND MANUALS

Although the definition of the employment relationship in a written contract is the best method of ensuring the legal responsibilities and rights of the parties, most employees do not have written agreements with their employers and serve as employees at will. Written employment agreements usually are used for senior management and key administrative persons in whom the employer has a significant business interest, to protect the employer by contractually ensuring the employees' availability for services with the company.

It has become customary for large businesses to publish and distribute **employee handbooks** or **manuals** governing the employment relationship between the employee and the employer. The information in these documents helps to ensure uniform administration of employment relations and personnel policies and to describe standards for the performance of duties and conduct of the employees. Common provisions include specific obligations assumed by the employer, such as compensation increases, benefit program coverage, vacation and sick leave benefits, and workplace accommodations and etiquette. The handbook usually describes expectations of the employer and permissible conduct of the employee on issues of absenteeism, dishonesty, insubordination, and disloyalty. Because of the proliferation of employment-related civil rights and discrimination legislation and judicial interpretations during the past decade, employers have found it necessary and desirable to state certain policies of the business in a published manual to advise all employees of the company's position on these important issues. For example, issues such as sexual harassment, which is considered under federal law as a form of discrimination, and other issues relating to discrimination are frequently addressed in policies describing the types of employee behavior that are unacceptable, the consequences for engaging in such behavior, and complaint and hearing procedures for resolution of any such incidents. Finally, the manual often sets forth progressive disciplinary and appeal steps to be followed in the event of employee misconduct or nonperformance, and states the method by which the employment relationship will be terminated.

In summary, the employee handbook provides a means by which an employer can explain the rules and policies concerning employment with the company and show that the company subscribes to a policy of fairness and equal treatment in employment matters covering a broad range of employee issues and disputes.

Employee handbooks are usually prepared internally by the company's human resources staff or personnel department, since they describe the specific employment issues that have been encountered in the company's history. The handbook should always be reviewed by the company's lawyer for legal sufficiency and to detect inadvertent (and costly) commitments to employees. Generally, the handbook will include the following topics:

1. Organization and administration of the company, describing the history, culture, ethics, and structure of the firm. The supervisory hierarchy of the company, including the management configuration and personnel-related committees, are normally described here. This section usually contains a statement concerning equal employment opportunity and the company's policy concerning discrimination or harassment issues.
2. Employee benefits and policies. This section describes the company's policies concerning holidays, vacation, sick time, leaves of absence, insurance, retirement plans, and other miscellaneous benefits, such as continuing education, legal services, direct banking arrangements available to employees, and the like. The description of benefits and policies should always provide for the employer to change the benefits and policies with appropriate notice to the employees.
3. General personnel policies. This section describes the procedures for payment of compensation, overtime, advances, and bonuses; procedures for updating personal information in the company's files; policies concerning promotions and lateral transfers; procedures for reporting accidents, soliciting fellow employees, expressing grievances, and personnel reviews; and policies concerning nepotism, alcoholism or drug abuse, and other work-related impairment issues. This section also usually describes the policies and procedures to be followed upon termination of employment, including voluntary resignation, disciplinary action, compensation upon termination, and policies regarding letters of reference.
4. General office procedures. This section covers topics such as working hours, personal conduct, facilities maintenance and use, completion of reports, and communication procedures within the company.

5. Administrative services. This section describes the services and facilities available to the employees and the methods by which their uses are regulated or limited. The use of the company's Internet Access, telephones, mail services, records, supplies, copy equipment, and other available items is a typical issue in this section.
6. Accounting and expense services. This section usually states the method by which disbursements are made, expenses are reimbursed, and accounting procedures are imposed.
7. Security and emergency procedures. This section deals with the rules of employee and company security and describes the procedures to be followed in an emergency.

Each employment manual is tailored to the specific policies and activities of the company, so only general statements concerning content can be made here. The employer should strive to include all items of policy or procedure about which there is a possibility of an employee misunderstanding or dispute. The rules must be written with clarity and precision to avoid confusion and uncertainty. On the other hand, the manual should be an expression of the business's guidelines and should be flexible enough for individual application in unique situations.

Employers historically distributed handbooks freely without concern that the statements or policies in the manuals had any legal significance. The guidelines were regarded as the employer's unilateral rules, freely modifiable by the employer (unless actually incorporated into a written employment agreement) and unsupported by any legal consideration, since the employee usually did not decide to accept employment based upon the rules in the manual and, in some cases, did not even learn about the manual until after being hired and completing a probationary employment period. However, recent employment cases have demonstrated that handbooks carelessly drafted without careful consideration of employment laws can create significant legal problems for the employer.¹³

The modern approach to employment manuals assumes that the manuals may become contracts of employment. Most courts considering the issue have imposed an objective test to determine whether an employee has a contractual right to enforce what is written in the employee manual: Would a reasonable person looking at the objective manifestations of the parties' intent find that they intended the manual to be a contract between them? Based upon this test, it is possible that not all statements contained in employee handbooks would be found to have created contractual rights and duties. For example, a statement that "an employee will be treated fairly and with dignity" is not likely to form the basis for a contractual obligation. Unspecific job security provisions, such as "an employee can expect a high degree of job security," are too vague to be actionable.¹⁴ However, statements concerning compensation and specific procedures for discipline and discharge may be enforceable by a disgruntled employee. Courts also may impose an **implied covenant of good faith and fair dealing** in the employment relationship and use the statements in the employee handbook as the baseline measure of whether the employer has acted in good faith and fairly. In addition, the policies and procedures in the handbook may be used as a basis for discrimination allegations. For example, if the handbook states that an employee may return to the company in an equivalent position following a leave of absence, a returning employee who is demoted following medical treatment for pregnancy may use the manual provisions to show discrimination.

The most common dispute to surface concerning employee manuals regards limitations on an employer's right to discharge an employee. A handbook contractually limits an employer's right to discharge an employee if the book contains a provision that is an express limitation to that effect, such as a statement that "an employee will only be terminated for cause." If an employee is able to identify a written provision in the manual in which the employer has expressly agreed to limit its rights to discharge the employee, a court will likely enforce the limitation. Even in the absence of an express provision, some courts have used the policies and procedures published in the book as a basis for an implied contract imposing limitations on termination. If the manual sets forth a disciplinary procedure by which an employee receives first an oral warning, then a written warning, and then discharge, the

employer will be required to follow that procedure. If the employer attempts to discharge an employee on the spot, even for extreme misconduct or insubordination, the employer could be liable for wrongful termination of the employment relationship. Similarly, if the manual describes a hearing and appeal procedure accompanying the discharge of an employee, the company must follow the procedure and ensure that the employee's hearing and appeal is substantive and fair.

Most benefits promised to employees by an employer in an employee handbook are enforceable by the employees. If the employer states that after retirement the employer will pay severance benefits or continue to pay life insurance premiums for the employee, the employer is legally bound to observe those promises. If any flexibility is desired by the employer, the handbook must contain an unambiguous and prominently displayed reservation-of-rights clause, permitting the employer to amend or cancel the described benefits at the employer's discretion. Most careful benefit administrators ask employees to sign a personnel form expressing their understanding of the company's right to modify its benefits and compensation arrangements at any time.

Counsel should review the company's employee handbook and ascertain carefully whether the statements contained in the book create express or implied promises upon which an employee could bring a claim against the employer. Several practices have developed in response to the recent proliferation of cases concerning these manuals to protect the employer from unwanted and unexpected legal liability. First, the book should not be distributed without a prominent, conspicuous statement that no contractual relationship is intended by the issuance and delivery of the manual. The book should state the employer's intention to create only an employment relationship at will. It also is usually advisable to include a similar statement in the company's application for employment form. Any waivers or disclaimers concerning benefit plans must be carefully drafted to comply with laws and regulations governing employee benefits, such as the **Employment Retirement Income Security Act (ERISA)**, discussed later in this chapter.¹⁵

To protect the employer and the employee from misunderstandings concerning the purpose and the legal enforceability of the handbook, the manual should begin with an explanation of the employer's intentions and the purpose of the book.

EXAMPLE

Beginning Disclaimer in Employer Handbook

Although we hope our relationship will be long and mutually beneficial, it should be recognized that neither you nor the Company has entered into any contract of employment, express or implied. Your relationship with the Company is and will always be "at will," which means your employment with the Company is voluntary, and you are free to resign at any time. Similarly, the Company is free to terminate your employment at any time, for any reason, with or without cause.

The information contained in this employee handbook is subject to change or elimination at any time by management without notice as business conditions and needs change.

Neither this handbook nor any other communication by any company representative, either written or oral, made before or when you are hired is intended in any way to create an employment contract. During your employment, no employee, officer, or other representative of the Company is authorized to give you any oral or written assurance of continued employment or of any other term or condition of employment, and you may not rely on any written or oral assurance of continued employment or any other term or condition of employment unless you receive any such assurance in writing from the Board of Directors.

It is also advisable to include an acknowledgment concerning the utility and purpose of the handbook on the employee's application for employment.

Application of Employment Acknowledgment

Acknowledgment

I acknowledge that I have received a copy of the Company's employee handbook dated _____, and I agree to familiarize myself with the handbook and to comply with the information the handbook contains.

I understand that my employment with the Company is and always will be "at will" and may be terminated, with or without cause, by me or by the Company at any time and for any reason. I also understand that no employee, officer, or other representative of the Company is authorized to make any oral or written assurance of continued employment, and that I may only rely on any such assurance if it is in writing to me from the Board of Directors.

I understand the handbook is intended to serve only as a guide to the Company's policies and procedures, and that the policies and procedures are subject to change or elimination without notice and at any time in the Company's sole discretion, as business conditions and needs change. I also understand that nothing in the handbook and no custom or practice of the Company is intended to be nor will they constitute a contract of any kind between the Company and me, including any contract regarding the length of my employment or any term or condition of my employment with the Company.

I understand I have an obligation to inform my supervisor, in writing, of any changes in the information I provided in my employment application, including my address, telephone number, and any change in my marital status and number of dependents for insurance and withholding purposes.

DATED: _____, 20_____.

(Employee Signature)

(Witness)

EXAMPLE

RESTRICTIVE AND PROPRIETARY COVENANTS

Although an employer may be unsuccessful in persuading a court to order an employee to continue to work for the company against the employee's will, the employer may prevent the employee from exploiting the company by appropriating ideas that were developed during the employment for the employee's own benefit; leaving with trade secrets, specialized confidential knowledge, or customer lists; or working for competitors. Certain **restrictive** or **proprietary covenants** in the employment agreement or signed by an employee at will as a condition of hiring may protect the employer from such abuse, and if properly drafted, these covenants will receive court protection.

The covenants generally cover three areas of possible employee exploitation: (1) competing with the company after employment; (2) maintaining confidentiality of business secrets during and after employment; and (3) using developments, inventions, and ideas that the employee produced during the course of employment. Without an agreement on each of these points, under common law the employer risks the loss of significant market advantages through the acts of unfaithful employees.

No former employee is prohibited from competing against a former employer without a specific agreement to that effect. The law has always favored fair and free competition, and there is nothing implicit in an employment relationship that requires the employee to withdraw from the marketplace after the employment is terminated. That is not to say, however, that the employee would be allowed to duplicate the former employer's secret practices and processes in future competition.

The law protects **trade secrets**, even without an agreement prohibiting their use, but the protection is somewhat elusive and unsatisfactory if left to common law resolution alone. First, it is difficult to determine which practices, procedures, and other matters are truly trade secrets entitled to protection. The employer has the burden to prove that the company is the "owner" of the secret, meaning the secret was developed by or for the company, is not used by others,

and is sufficiently unique so as to deserve legal protection. Further, the employer must show that the secret is known only to company employees in whom it must be confided for business purposes. Even if the matter were shown to be a trade secret, a court would have to be convinced that the employee's exploitation should be prohibited. The court would have to find that the employee's use or publication of the secret could cause irreparable harm to the employer. An agreement restricting the employee's use of trade secrets is essential for certainty of protection in this area.

The common law is also unpredictable on the question of an employer's rights in an employee's original ideas and developments discovered during the course of employment. Certainly, if the employee is hired to do research and create inventions, the employer has ownership rights in any productive research while the employee is on the job. But what happens if the employee dreams up an invention that is unrelated to the employer's research, or if the employee quits before research is productive and subsequently produces an invention for the personal benefit of the employee? Specific provisions in the agreement may anticipate and resolve these problems.

EMPLOYER'S RIGHT TO EMPLOYEE WORK PRODUCT

The employer may have hired the employee for the express purpose of developing new products or business innovations. Certain specialized skills, such as research chemistry or engineering, are widely sought for this purpose, and the employment relationship is directed to the production of inventions. The employee also may be hired to develop certain business practices and procedures that will increase efficiency and utilization of other employees' skills. These common cases should be distinguished by the test of a **work product** that can be legally protected. In the first case, an invention from the original thought of an engineer may be patentable and thereby have certain proprietary interests attached to it. In the second case, a particular procedural system devised by a time-and-motion expert may be unique, but will not be such a unique, original creative product that a patent or copyright could be obtained. The employer's interest in each may be indistinguishable, however. The company obviously wants to retain proprietary rights in patentable inventions, and management may be equally concerned about reserving newly devised business procedures to themselves for the associated competitive advantages. The clauses suggested here will protect the company's rights to the patentable inventions, but they may not be adaptable to protection of other unpatentable work products. Rather, in the second case it would be more appropriate to describe the developed business procedure as a trade secret in the agreement and thereby ensure some confidentiality, or to prohibit the development of a similar system for a competitor through a noncompetitive covenant with the employee.

Work product clauses are most effective for inventions and other original creations that are so unique that they are capable of being patented or copyrighted. A work product clause should include at least the following general components:

1. a specific grant from the employee to the employer of the right to use the work product;
2. a statement that the clause applies to any use to which the employer chooses to make of the work product;
3. a statement that the clause applies to inventions, designs, procedures, and other matters in both their unperfected and improved states;
4. a statement that the clause applies to inventions, designs, and other matters developed or obtained by the employee alone or severally or jointly with other persons;
5. a statement that the clause applies to the entire period of the employment with the employer;
6. a specific description of the employee's talents out of which inventions and designs are expected to be produced;
7. a specific description of the type of inventions, designs, and other matters the employee is expected to develop;

8. a general statement that other inventions or designs, and other matters that relate to the employee's product will be covered by the clause;
9. a release by the employee of any legal or equitable right to the work product;
10. a promise by the employee that all necessary documents for assigning and transferring ownership will be executed and delivered to the employer on demand;
11. a representation by the employee that the work product will not infringe upon any patents or protected rights of others;
12. any special compensation arrangements that have been negotiated with the employee for subsequent use of the invention, design, or work product;
13. an agreement that the work will be protected by statutes governing trade secrets to protect against its publication before a patent, copyright, or other protected proprietary rights may be obtained; and
14. the relief or remedies to which the employer may be entitled for a breach of the clause, such as injunctions, liquidated damages, a constructive trust on all profits produced, and so forth.

The scope of these provisions is usually determined by the nature of the employment. For example, if an employee is hired for the broad purpose of researching and developing improvements in elevators, a broad protective grant of a license would be appropriate.

Grant of License

EXAMPLE

The Employee hereby grants to the Employer the exclusive license to manufacture, sell, and deal in all inventions, designs, improvements, and discoveries of the Employee, whether now perfected or whether invented, improved, and discovered subsequent hereto, which pertain or relate to elevators and their appliances, or are capable of use in connection therewith.

If the employment objective is more specific, such as the research and development of a valve and starter plug to improve elevator control, the clause may be more specific.

Inventions Designated as the Property of the Employer

EXAMPLE

The Employee agrees that all inventions, improvements, ideas, and suggestions made by him or her and patents obtained by him or her severally or jointly with any other person or persons during the entire period of his or her employment, and any written renewal thereof made by him or her with the Employer, with relation to said valve and its appurtenances, including present starting plug, or method of elevator control, and all inventions of elevator valves, plugs, or methods of elevator control and valve appliances, and to machinery for manufacturing the same, are and shall be the sole property of the Employer, free from any legal or equitable title of the Employee, and that all necessary documents for perfecting such title shall be executed by the Employee and delivered to the Employer on demand.

The specificity of the clause may be a matter for negotiation between the parties. The employee in the second example may have insisted upon the narrow description so that his or her subsequent development of an elevator door, for example, would not belong to the employer. However, the employee may be willing to consent to the broader provision for increased compensation. The employer's objective is to make the subject matter of the clause all-inclusive.

Work product protection clauses should always require the execution of any necessary documents for perfecting the employer's title to the inventions, as shown in the second example. This requirement may obviate any need for an interpretation of the contract before the employer can market the invention, and the clause will place the employee in breach of the agreement if the employee fails to cooperate fully with the employer. It is also desirable to contract

for trade secret protection of the invention to protect against the invention's publication before a patent may be obtained. A clause on these points follows.

EXAMPLE

Execution of Further Documents

I further agree, without charge to said company, but at its expense, to execute, acknowledge, and deliver all such further papers, including applications for patents, and to perform such other acts as I lawfully may, as may be necessary in the opinion of said company, to obtain or maintain patents for said inventions in any and all countries and to vest title thereto in said company, its successors and assigns; and I further agree that I will not divulge to others any information I may obtain during the course of my employment relating to the formulas, processes, methods, machines, manufacturers, compositions, or inventions of said company without first obtaining written permission from said company to do so.

It may be appropriate (and necessary, if the employee skillfully negotiates the agreement) for the employer to compensate the employee based upon the profitable inventions the employee has created for the company. The percentage compensation scale can be tailored to the demands of the parties, and might look like this:

EXAMPLE

Compensation for Inventions

In order to recompense the above employee (hereinafter called the Employee) for meritorious inventions, the Company agrees on its part to examine the inventions disclosed to it by the Employee, and where said inventions, in the sole opinion of the Company, warrant such action, to cause United States patent applications to be filed through its attorneys covering the same, but without assuming any responsibility for the prosecution or defense of such patent applications, and further agrees to give to the Employee in any cases where it decides to license said inventions, applications, or patents to others, a percentage of any money royalties that it may receive from such licenses upon the following scale:

- Of the first \$10,000 or part thereof collected in any one calendar year—40%
- Of the next \$20,000 or part thereof collected in any one calendar year—30%
- Of the next \$30,000 or part thereof collected in any one calendar year—20%
- Of the next \$50,000 or part thereof collected in any one calendar year—15%
- Of all further sums collected in any one calendar year—10%

It is understood and agreed, however, that the question of when, how, and to whom licenses shall be granted shall be in the sole discretion of the Company, and that in cases where the Company shall grant licenses involving, in addition to the Employee's inventions, the inventions of others, the Company shall have the sole right and authority to apportion the royalties received, and the Employee shall receive the above percentage on the proportion awarded to his or her inventions.

TRADE SECRET PROTECTION

Beginning with the truism that various companies have various secrets, some more important than others, trade secret protection must always be drafted to fit the particular needs of the company. A discount retail merchant may consider its supplier list to be a trade secret; a manufacturing company may consider the assembly process to be a trade secret; and a computer firm would treat its programs and techniques for interpretation as trade secrets. In each business, the "secret" is an integral part of the competitive advantage, and confidentiality is deemed to be crucial to continued success of the operation. In part, this mystery is a result of using well-drafted employment agreements (or **nondisclosure agreements**) and never completely disclosing the secret process to anyone (see Exhibit 12-1, Nondisclosure Agreement).

Exhibit 12-1.

Nondisclosure Agreement

NON-DISCLOSURE AGREEMENT

NON-DISCLOSURE AGREEMENT
Covering Inventions, Discoveries, and Confidential Matter

In consideration of my employment, or my continued employment, as the case may be, by _____, a Delaware corporation (hereinafter called the Company), I agree with the Company as follows:

So long as I shall remain in the employ of the Company I will devote my whole time and ability to the service of the Company in such capacity as it shall from time to time direct, and I will perform my duties faithfully and diligently.

I will not, during my employment or thereafter, use or disclose to others without the written consent of the Company, any trade secrets, secret "know-how", confidential or secret technical information or other confidential information relative to your business obtained by me while in the employ of the Company. Upon leaving the employ of the Company I will not take with me any confidential data, drawings, or information obtained by me as the result of my employment, or any reproduction thereof. All such Company property will be surrendered to the Company on termination or at any time on request.

I will disclose to the Company and, upon the Company's request, assign to it, without charge, all my right, title and interest in and to any and all inventions and discoveries which I may make solely or jointly with others, while in the employ of the Company which relate to or are useful or may be useful in connection with business of the character carried on or contemplated by the Company, and all my right, title and interest in and to any and all domestic and foreign applications for patents covering such inventions and discoveries and any and all patents granted for such inventions and any and all reissues and extensions of such patents; and upon request of the Company whether during or subsequent to this employment I will do any and all acts and execute and deliver such instruments as may be deemed by the Company necessary or proper to vest all my right, title and interest in and to said inventions, applications, and patents in the Company and to secure or maintain such patents, reissues and/or extensions thereof. Any inventions and discoveries relating to the Company's business made by me within one year after termination of my employment with the Company shall be deemed to be within this provision, unless I can prove that the same were conceived and made following said termination. All necessary and proper expenses in connection with the foregoing shall be borne by the Company, and if services in connection therewith are performed at the Company's request after termination of employment, the Company will pay reasonable compensation for such.

Attached hereto is a list of patent applications and unpatented inventions made prior to my employment by the Company, which I agree is a complete list and which I desire to remove from the operation of this agreement.

This Agreement shall inure to the benefit of the Company, its subsidiaries, allied companies, successors and assigns or nominees of the Company, and I specifically agree to execute any and all documents considered convenient or necessary to assign, transfer, sustain and maintain inventions, discoveries, applications and patents, both in this and foreign countries.

IN WITNESS WHEREOF, I have hereunto signed my name and affixed my seal, this _____ day of _____, 20____.

Witness: _____ (SEAL)
 _____ (DEPT.)

Distribution: Execute in triplicate -- White copy for Department, yellow copy for Employee; and pink copy for Personnel Relations Department.

Several important rules should be followed in drafting trade secret clauses for employment contracts. First, the promise to keep the secrets should bind the employee during the employment and after termination of employment. Second, the clause should cover not only specific secrets that the employee uses in performing duties under the agreement, but also secrets the employee may have learned from alert observations or from other employees. Third, the agreement should broadly prohibit divulging any "trade secrets, procedures, processes, or knowledge of operations," and should specifically itemize particular matters that are to be protected. Fourth, because of the difficulty of proving actual damages from the publication of a trade secret, an agreed damage clause, or **liquidated damages**, should be considered. A clause with all of these ingredients follows.

EXAMPLE**Trade Secrets**

The Salesperson further covenants not to communicate during the continuance of this agreement, or at any time subsequently, any trade secrets, processes, procedures, or business operations, specifically including but not limited to information relating to the secrets of the traveling, advertising, and canvassing departments, nor any knowledge or secrets he or she then had or might from time to time acquire pertaining to other departments of the business of the Employer, to any person not a member of the Employer's firm, except as requested in writing by the Employer. In case of violation of this covenant, the Salesperson agrees to pay the Employer or its successors the sum of \$5,000 as liquidated damages, but such payment is not to release the Salesperson from the obligations undertaken, or from liability for further breach thereof.

It also would be advisable to prohibit the employee's use of the secret as an individual, or the employee's direct or indirect benefit from the use of the secret, such as when a shareholder, partner, employee, consultant, creditor, or other participant in another business learns about or adopts the secret from the employee. It is also customary to agree that the employer will be entitled to injunctive relief against the person using the trade secret to stop such use and avoid irreparable harm to the employer's business.

Customer lists commonly are covered in trade secret clauses, since courts are not likely to construe customer lists as a business secret under common law so as to shelter them without an agreement. However, in highly competitive businesses, the secrecy of customer lists is an important competitive advantage. A competitor who obtains them will be spared considerable time and expense in locating interested customers. Depending upon the nature of the business, customer list protection may not need to extend indefinitely after termination of employment. The list may change significantly within a year or two, and the contractual provision may be so limited.

EXAMPLE**Customer Lists**

The Employee further agrees that during the period of one (1) year immediately after the termination of his or her employment with the Employer, he or she will not, either directly or indirectly, make known or divulge the names or addresses of any of the customers or patrons of the Employer at the time he or she entered the employ of the Employer or with whom he or she became acquainted after entering the employ of the Employer, to any person, firm, or corporation, and that he or she will not, directly or indirectly, either for himself or for herself or for any other person, firm, company, or corporation, call upon, solicit, divert, or take away, or attempt to solicit, divert, or take away any of the customers, business, or patrons of the Employer upon whom he or she called or whom he or she solicited or to whom he or she catered or with whom he or she became acquainted after his or her employment with the Employer.

The Employee hereby consents and agrees that for any violation of any of the provisions of this agreement, a restraining order and/or an injunction may issue against him or her in addition to any other rights the Employer may have.

In the event that the Employer is successful in any suit or proceeding brought or instituted by the Employer to enforce any of the provisions of this Agreement or on account of any damages sustained by the Employer by reason of the violation by the Employee of any of the terms and/or provisions of this Agreement to be performed by the Employee, the Employee agrees to pay to the Employer reasonable attorneys' fees to be fixed by the Court.

COVENANTS NOT TO COMPETE

Unlike the foregoing restrictive provisions governing the employer's ownership rights to the employee's work product and the protection of trade secrets and other confidential information, a **covenant not to compete** does not endeavor to solidify the company's ownership rights. Rather, this covenant is designed to prevent the employee from using personal talents (which were probably developed or improved during the employment) against the employer. Although an employer is entitled to protection from an employee's competition *while em-*

ployed by the employer under common law principles of fiduciary duty and theft of the employer's business opportunities, covenants not to compete are often included in an employee's agreement prohibiting competition during employment so that the employee's loyalty is clearly defined and easily enforced according to the terms of the agreement. These covenants are most often enforced against former employees who have left the employer's business and are attempting to compete against the employer based upon what they have learned while working there.

The negative objective causes some problems. Consider the plight of a research chemist who is an expert in industrial cleaning solutions. If he is a party to an employment contract that contains a clause forbidding future employment with any other industrial cleaner manufacturer, upon termination of his employment, he will lose his livelihood. His specialized technical knowledge significantly reduces his professional flexibility, and he must either breach the agreement or develop a new expertise. The company's objective is to prevent the employee from using his or her technical abilities to benefit a competitor, and the more specialized the skill, the more important it is for the company to discourage its marketability after termination. There is a bit of a tug of war here. If the restriction is too severe, a court simply will not enforce it; if it is too loose, the company cannot enforce it.

Many courts are very reluctant to enforce noncompetition agreements for several reasons. First, a noncompetition agreement is a restraint of trade, which is normally illegal both in common law and under state and federal antitrust statutes. However, limited noncompetition covenants are lawful and enforceable if they are agreed in conjunction with an otherwise legitimate agreement. Generally, a reasonable noncompetition agreement will be enforced if it is necessary for the protection of the employer, imposes no undue hardship on the employee, and does not injure the general public. Because courts are frequently reluctant to enforce noncompetition agreements, many states have adopted statutes that severely restrict the use of such covenants. In some states, all restrictive competition covenants are void except when given in connection with the sale of a business or the dissolution of a partnership.¹⁶ Other states permit such clauses in employment contracts, but limit the effectiveness to certain justifying characteristics, such as training or advertising expenses, a license to practice, executive or management personnel, or specific territory limitations.¹⁷

Almost uniformly, the enforceability of a covenant not to compete depends upon whether the covenant is "reasonable," the determination of which includes consideration of the following:

1. the legitimate needs of the employer for such protection;
2. the interest of society in preventing monopolies or other excessive restrictions on competition;
3. the burden placed upon the employee;
4. whether the employee has had frequent contacts with customers or clients of the employer;
5. whether the employer's business relies to a substantial degree on trade secrets to which the employee had access;
6. whether the employer provided training to the employee;
7. whether the employer's business is highly technical or complex;
8. whether the employer's business is highly competitive;
9. whether the employee, while employed, was a key employee, such as a manager or executive;
10. whether the employee provided unique services while employed by the employer;
11. whether the covenant exceeds boundaries of time, space, and type of activity that are reasonably required to give the employer the protection to which the employer is entitled;
12. whether there is a clear disparity of bargaining power between the employer and the employee; and
13. whether the employee understood the nature of the covenant at the time it was signed.

The drafting of a noncompetition clause with these considerations in mind is a delicate operation.

One rule is absolute: a noncompetition clause may never prohibit the employee from engaging in competitive activity indefinitely. The protection of the clause must have a reasonable basis in fact, and no employer will be able to convince a court that competitive activity by a certain employee will forever cause irreparable harm to the business. Consequently, the clause should be limited to a specified period during which the company will be justified in keeping the employee out of the market to preserve a competitive advantage.

From the employer's standpoint, the agreement should also provide that the employee is prohibited from competition upon termination "for any reason whatsoever." An employee who has left to work for a competitor before the expiration of the agreement cannot expect much sympathy from a court. However, an employee who has been fired and must now refrain from marketing personal talents is in a different position. Without the language suggested above, a court may narrowly construe an employee's termination and enforce the noncompetition clause only when termination results from the employee's initiative.

To enforce a noncompetitive agreement, the employer may have to show a court that the former employee's competitive activities are causing irreparable harm to the company. The difficulties of producing such proof may be avoided by exacting a consent to injunctive relief against the employee should the employee violate the agreed provisions.

Finally, the competitive activities that are to be prohibited and the geographical limits of the prohibition should be specified with accuracy and clarity. If the provision is overly broad, it is less likely to be enforced in litigation involving its breach. Moreover, any ambiguity will always be resolved against the drafter, meaning the employer. For example, a provision that prohibits the employee from working in "the retail sales industry" is useless. A description of "retail sales of men's wear" is better but questionable because it is so broad. Equally unenforceable is a provision that prohibits the employee's competition in the "western part of the United States." The "South Dakota area" may be enforceable but requires a great deal of interpretation and undoubtedly would be limited to the boundaries of the state. The defined activities and geographical area should be consistent with the activities and market of the employer and should be specific. Consider the strengths and weaknesses of the following examples.

EXAMPLE

Agreement Not to Compete

I also agree that I will not work for any competitive company or for myself to sell directly or indirectly milk or milk products in the same territory covered by me either as route salesman or foreman of routes for a period of at least one year after termination of my employment, voluntarily or involuntarily, with this Company.

EXAMPLE

Covenant Not to Compete

It is further agreed by the Employee that the sale of the Employer's petroleum products in the trading area hereinbefore referred to is a valuable asset to the Employer, and in order to promote the sales of petroleum products in said trading area, the Employer will make expenditures through advertising and otherwise, and in consideration of the covenants and agreements herein contained, the Employee agrees that in the event of the termination of this contract for any reason, with or without cause, the Employee will not engage in the sale of gasoline, fuel oils, or petroleum products, directly or indirectly, either on her own account, or as an employee for any other person, firm, or corporation, in the city of Chicago, Cook County, Illinois, for a period of five (5) years following the termination of this contract.

Agreement and Covenant Not to Compete

EXAMPLE

The Employee further covenants and agrees that at no time during the term of this employment, or for two (2) years immediately following termination thereof (regardless of whether such termination is voluntary or involuntary), will he for himself or in behalf of any other person, partnership, corporation, or company, engage in the pest control business or any business engaged in the eradication and control of rats, mice, roaches, bugs, vermin, termites, beetles, and other insects within the territory known as cities of Spearfish and Belle Fourche, South Dakota, and a radius of 25 miles of each of said cities, nor will he directly or indirectly for himself, or in behalf of or in conjunction with any other person, partnership, corporation, or company, solicit or attempt to solicit the business or patronage of any person, corporation, company, or partnership within the said territory for the purpose of selling a service for the eradication and control of rats, mice, roaches, bugs, vermin, termites, beetles, and other insects, and such other incidental business and service now engaged in by the Company, nor will the Employee disclose to any person whatsoever any of the secrets, methods, or systems used by the Company in and about its business.

The Employee hereby consents and agrees that for any violation of any of the provisions of this agreement, a restraining order and/or an injunction may issue against him in addition to any other rights the Employer may have.

It is better practice to specifically define the boundaries in which competition is prohibited. For example, describing county lines or city limits is preferable to providing a point from which a radius will be computed. The larger the geographical area, the less likely it is that the covenant will be enforced. If the employer is engaged in the sale of goods within a particular city, it would be inadvisable to define noncompetition to include the entire state, even if the employer plans to expand operations to the entire state, since a court will be more concerned with the actual needed protection at the time the covenant was signed than with speculation about expansion and potential competitive problems in the future.

The clause should provide that the employee understands the nature of the covenant and consents to the covenant's prohibition of the employee's activities that may compete with the employer. Further, the covenant should specify that the employee understands that the clause is necessary for the employer's protection, and that the employee agrees that any violation of the clause will do irreparable harm to the employer.

The employee should be prohibited from directly or indirectly competing with the employer as an owner, manager, operator, or controlling person, or through being employed by, participating in, or being connected in any manner with the ownership, management, operations, or control of a competitor, including holding a position as a creditor. A classic avoidance technique for these covenants involves former employees who loan money to a new corporation that will compete with the former employer. In exchange for the loan, these "creditors" receive convertible debentures that will be converted to common stock (and majority ownership of the corporation) the day after the former employees' covenants not to compete expire.

If the covenant will be regulated by a statute in the jurisdiction in which it is to be enforced, the specific statutory reason for the covenant (such as because the employee was trained by the employer, or because the employee is a member of the management or executive personnel) should be stated in the covenant.

The clause should contain **severability provisions**, which allow for the removal of any objectionable portion of the clause without affecting the enforcement of the remainder of the clause for the employer's protection.

Consideration should be given to penalties other than injunctive relief or damages, such as loss of accrued but unpaid commissions, loss of retirement or profit sharing incentives, and similar penalties that discourage but do not forbid one from entering into competition.

The fair objective of restrictive covenants in employment contracts is to protect the legitimate interests of the company without unduly restricting the activities of the employee.

Properly drafted restrictions never exceed the limits of necessary company protection and are firm and thorough on those points, thereby affording a better opportunity to have them do what they are supposed to do.

INCENTIVE COMPENSATION PLANS

Employee incentive is a key element to current performance and continued employment with the company. Individual incentive compensation terms for individual employment contracts have been discussed previously.¹⁸ It may be desirable, however, to use **group incentive plans** in lieu of or in addition to individual incentive provisions in each agreement. As the number of beneficiaries to an incentive compensation plan grows larger, however, the plan becomes less effective as a true incentive. For example, an individual salesperson can be easily motivated by a personal incentive based directly on individual sales, but personal motivation is more tenuous if the entire sales division, comprising many salespersons, is rewarded for the aggregate performance of all.

As with personal incentive plans, a cardinal rule for the effectiveness of a group incentive plan is that the compensation must be related directly to the performance of an ascertainable division of the company. In practice, these incentive plans are usually directed to key employees, since key employees motivate other employees to concentrate their efforts toward the employer's growth and profits, and further provide an incentive for other employees to remain with the company.

A group plan is properly administered under the direction of a committee, which, in the case of a corporation, may be, but does not have to be, composed of the directors. Persons who are entitled to compensation under the plan should not be members of the committee. The committee is usually vested with some discretion to determine the amount of the incentive awards and the recipients from among those eligible to participate in the plan.

The written plan should begin with a statement of purpose, which usually indicates an intent to provide incentives to certain employees by enabling those employees to participate in the success of the company. The eligible participants in the plan must be clearly defined, as should the base accounts from which the amounts awarded under the plan will be determined. For example, if the participants under the plan are to receive a certain percentage of *profits*, that word must be defined, specifying whether taxes, allocations of overhead, contingent or unusual expenses, and so on are to be deducted. The formula for compensation under the plan may refer to multiple accounts, such as a percentage of the extent to which profits exceed capital, and all stated accounts should be clearly defined.

The membership of the committee is set forth in the plan, and the committee's duties and term of membership should be prescribed. If the committee is to have discretion in granting the incentive awards, a procedure for determination of the recipients, with specified guidelines for merit, may be provided. Alternatively, a formula may be drafted that makes the application of the awards a mechanical task for the committee, but the use of such a formula minimizes the flexibility of the plan by removing the committee's discretion from the incentive characteristics. True merit may be rewarded at the committee's discretion, but a formula may not account for that.

A method for determining the amount of the fund must be included in the plan. A percentage of the defined revenue or profits is the most simple method; the complex formulas of other methods defy the imagination. The fund is usually set aside in an incentive compensation reserve account, awaiting the directions of the committee.

The payments under a corporate incentive plan may be made in cash or a stock equivalent, based upon the current market price of stock. If the stock is reported on a national exchange, a method is prescribed to compute market price, such as "the average daily opening price on the exchange during the calendar month preceding the month of award." The committee may decide whether the award is to be in cash or stock, and the committee also should have the authority to pay the award immediately or to defer payment in whole or in part. If deferral is permitted, separate accounts must be maintained for that purpose. The deferral of the award may provide certain tax benefits to the employees.¹⁹

Additional incentive thrust results from imposition of conditions upon payment of the compensation. For example, the terms of the plan may refuse payment to an eligible participant if that employee resigns during the year without the consent of the company. The plan may further deny deferred payments if a former employee is subsequently employed by a competitor of the company. It is also common to provide for forfeiture of any award if the employee is discharged for misconduct. The plan should specifically state that the employee has no claim or right to be granted an award under the plan, and the plan should not be construed as granting the participant a right to be retained in the employ of the company.

The company management should be granted authority to modify or suspend the plan at their discretion, but only prospectively so as not to affect any rights of employees working in reliance on the incentive benefits under the plan. Management should not be able to retroactively affect the rights of employees with respect to unpaid awards previously granted. Finally, a corporate incentive plan should be approved by the shareholders, especially if it contemplates the issuance of stock as an incentive award.²⁰

DEFERRED COMPENSATION

Key employees and executives may be plied with an incentive to remain with the company by a **deferred compensation plan**. These plans are designed to meet two important objectives in the employment relationship: (1) income for the employee is deferred until the employee retires or becomes incapacitated, providing necessary security and allowing receipt when the employee's income is taxed in a lower bracket; and (2) the employee is given an incentive to remain with the company to receive accumulated retirement benefits. The agreement for a deferred plan may be incorporated into an employee agreement or may be executed separately after a period of satisfactory employment.

The amounts of compensation to be deferred may be determined by a number of methods. A portion of base salary may be deferred, or a percentage of salary in addition to normal base salary may be used. The deferral provisions also may be tied to bonus or incentive plans, such as those described in the preceding section.

The deferred income is retained in a fund for the employee until payment at the prescribed time, usually following retirement or disability. Payment may be in a lump sum or in installments over a period of years.

Retirement Date

The Company agrees that Patricia Smith may retire from the active and daily service of the Company upon the first day of the month nearest her sixty-fifth birthday.

EXAMPLE

Retirement Compensation

The Company agrees that commencing with the date of such retirement, it will pay to Patricia Smith the sum of \$36,000.00 per annum payable in equal installments of \$3,000.00 each, payable upon the first business day of each calendar month. The Company agrees that it will continue to make such payments to Patricia Smith during her lifetime, and with no liability to make payments to her legal representatives, for ten (10) years and until Patricia Smith shall have received one hundred twenty (120) monthly payments of \$3,000.00 each; subject, however, to the conditions and limitations hereinafter set forth.

EXAMPLE

The incentive to continue with the company results from the continual increase in the deferred fund and from the terms of the agreement, which typically conclude all rights and obligations under the agreement if the employee voluntarily terminates the employment relationship without the consent of the company.

EXAMPLE**Termination of Employment**

If Patricia Smith shall voluntarily terminate her employment during her lifetime and prior to her said retirement, or if her employment shall be terminated for sufficient cause as determined by the Board of Directors of the Company, this Agreement shall automatically terminate and the Company shall have no further obligation hereunder.

These agreements also frequently prescribe a **forfeiture** of all benefits under the plan if the employee subsequently engages in competition with the company.

EXAMPLE**Covenant Not to Compete**

Patricia Smith agrees that during such period of receipt of monthly payments from the Company, she will not directly or indirectly enter into or in any manner take part in any business, profession, or other endeavor either as an employee, agent, independent contractor, owner, or otherwise in the City of Fort Lauderdale, Florida, that in the opinion of the directors of the Company shall be in competition with the business of the Company, which opinion of the directors shall be final and conclusive for the purposes hereof.

EXAMPLE**Forfeiture**

Patricia Smith agrees that if she fails to observe any of the covenants hereof and continues to breach any covenant for a period of thirty (30) days after the Company has requested her to perform the same, or if she has entered any business described in the preceding paragraph and continues therein, either directly or indirectly, as aforesaid for a period of fifteen (15) days after the Company has notified her in writing at her home address that the directors of the Company have decided that such business is in competition with the Company; then, any of the provisions hereof to the contrary notwithstanding, Patricia Smith agrees that no further payments shall be due or payable by the Company hereunder either to Patricia Smith or to her spouse, and that the Company shall have no further liability hereunder.

In addition to their incentive character, the forfeiture clauses serve another useful purpose. The tax benefits from a deferred compensation plan may be generally stated to be that the company may deduct the payments to the deferred fund when paid, but the employee need not declare the payments as income until those payments are received. The latter rule is based upon the condition that the employee does not “constructively receive” the payments earlier—that is, the employee does not earn a vested right to the payments before they are paid. The conditions described earlier avoid the **constructive receipt** problem, since the employee’s continuous performance and prohibition against competition are superimposed upon the employee’s right to payment and prevent any vesting of the employee’s interest until the conditions are satisfied.

The deferred compensation plan should divert the payment of the deferred income to the employee’s heirs in the case of the employee’s death.

EXAMPLE**Payments to Spouse If Employee Dies after Retirement**

The Company agrees that if Patricia Smith so retires but dies before receiving the said one hundred twenty (120) monthly payments, it will continue to make such monthly payments, to Fred Smith, her spouse, if he survives Patricia Smith, until the total payments made to Patricia Smith and her spouse equal \$180,000.00; provided that if Fred Smith survives Patricia Smith but dies before the said amount is paid by the Company, the Company shall have no liability to continue any payments hereunder beyond the first day of the month in which Fred Smith died.

Death of Spouse after Retirement

EXAMPLE

If Patricia Smith so retires and her spouse does not survive her, the Company shall not be required to continue any payments hereunder beyond the first day of the month in which Patricia Smith dies.

Payments to Spouse If Employee Dies before Retirement

EXAMPLE

If Patricia Smith dies before the aforesaid retirement date and her spouse survives her, the Company agrees to make the said monthly payments hereinbefore described to the said Fred Smith, commencing with the first day of the month following the month in which Patricia Smith dies and ending when one hundred twenty (120) monthly payments have been made to Fred Smith or until and including the first day of the month in which Fred Smith dies, whichever event shall first occur.

Death of Employee before Retirement with No Spouse Surviving

EXAMPLE

If Patricia Smith dies before the said retirement date, the Company shall not be required to make any payments hereunder.

PENSION AND PROFIT SHARING PLANS

Pension and profit sharing plans are deferred compensation plans, but they may produce additional tax benefits for the employer and the employee if they qualify under the Internal Revenue Code.²¹ Whether a particular plan qualifies under the Internal Revenue Code depends upon compliance with complicated tax rules that are discussed later in this section. Both pension and profit sharing plans accumulate and defer income until some future date. The employer's objective is to induce the employee to remain with the company to receive accumulated retirement benefits. The profit sharing plan also adds a current performance incentive, since the amount contributed to the plan is based upon profits produced by the employee and the employee's coworkers.

Both profit sharing and pension plans are directed toward retirement or disability income and faithful performance. However, each plan reaches the objective by different means. The profit sharing plan is based upon profits, and the employer's contribution to the fund is couched in terms of a percentage of annual profit. From the employer's standpoint, a profit sharing plan is less onerous than a pension plan. It is subject to special tax rules, since the obligation to contribute depends upon the profitable operation of the business, and there is no fixed obligation to contribute annually. The contribution requirements reflect the economic cycles of the business, and as a result the plan is more flexible than a pension plan. The size of the fund will depend entirely upon the profits contributed throughout the duration of the plan. Allocation of the fund to individual employees is usually based upon employees' compensation during their periods of employment. These factors result in a minimal burden for the employer and, if incentives are taken seriously, greater benefit to the employees. Young, aggressive employees who intend to remain with the company will particularly benefit. Their efforts in producing profit increase their compensation under the plan, and as they remain with the company, their share of the profits distributed to the fund will increase as their base compensation increases. Finally, it is possible to provide for periodic withdrawals from the profit sharing accounts in addition to distribution upon retirement, death, or disability.

Pension plans, on the other hand, are specifically directed toward retirement income, and the employer is usually obliged to contribute the necessary funds on an annual basis. Pension plans may be either defined benefit plans (where the exact benefits upon retirement are specified and contributions must be made to reach the specified benefits) or defined contribution plans (where a certain contribution is made by the employer each year and the benefits depend

on the total funds available upon retirement). The benefits of the plan provide a specified income for the employee after retirement, and the employer contributions are fixed by an amount necessary to provide income for the specified period. The employer contributions are a fixed annual obligation and are not related to profits in any way. The contribution is, therefore, a charge on operations that must be considered in estimating costs and pricing. Moreover, the contribution is usually directly based upon the employee's length of service and age, since the contribution for an older employee must be higher to accumulate enough funds for that employee's specified retirement income under the plan. The allocation of funds among eligible employees under the plan will be in accordance with the prescribed pension, and young, aggressive employees are not particularly rewarded for their enthusiastic business achievements. However, the fixed obligation to contribute to the pension plan has some employee advantages that are not available with a profit sharing plan. The pension plan permits recognition of employment before the establishment of the plan, and accommodates immediate pensions for employees who have already reached retirement age when the plan is adopted.

The general distinction between types of plans can be summarized as follows:

Defined Benefit Plan

Includes pension plans

Benefits calculated by a formula based upon years of service and average compensation

Benefits cannot exceed the lesser of (i) 100% of the participant's average earnings in the three best-paid years of employment or (ii) a dollar amount specified in the statute

Forfeitures cannot increase benefits to any participant (must be used to pay expenses)

Minimum funding required

Best for older employees since benefits can be funded over a shorter time

Defined Contribution Plan

Includes profit sharing, qualified deferred compensation, and employee stock ownership plans

Each participant has an account that includes contributions, investment income, and forfeitures of terminated participants

Contributions to an account cannot exceed the lesser of (i) 25% of the participant's compensation (15% for a profit sharing plan) or (ii) a dollar amount specified in the statute

Forfeitures may be allocated to the account of the remaining participants

No minimum funding required

Best for younger employees since higher benefits will result over a longer period of time

The choice among the types of plans depends on many factors, the most important of which include the ability of the company to make the required contributions, the desired stimulation of incentive, and the characteristics of the employee group. A combination of both plans may be used to benefit all employees.

Tax Ramifications

The tax treatment of profit sharing and pension plans is complicated and should be thoroughly studied before a plan is recommended or drafted. Only a few of the most important provisions are covered here.

Tax-favored plans must be qualified, meaning they must satisfy the statutory requirements prescribed in the Internal Revenue Code.²² A qualified plan results in tax benefits for both the employer and the employee. Subject to certain statutory limitations, the employer is permitted to deduct contributions to the plan in the year made, just as normal compensation would be deducted as an expense, even though the compensation is not actually paid to the employee during that year.²³ Therefore, the employer suffers no tax disadvantage by paying compensation to the plan, rather than paying directly to the employee. The funds paid into the plan may be

accumulated and invested during the holding period, but the income earned on the investment is exempt from any tax.²⁴ The funds thereby increase much faster than if they were invested by the corporation without a qualified plan or by the individual employee. The employee-beneficiary of the plan is not taxed on any of the funds until those funds are distributed.²⁵ Thus, an executive who receives a substantial salary that elevates his or her tax bracket at the height of his or her earning power will not lose a proportionate amount of the compensation under the plan by having to pay tax on this deferred income in the years he or she is employed. Rather, the employee will pay tax on distributed amounts received in years of retirement, when his or her other income is likely reduced and his or her tax bracket is much lower. Finally, the amounts contributed by the company and paid to heirs or beneficiaries upon the death of the employee can pass free of estate tax, since the employee may specify direct payment to named beneficiaries and the funds will not be included in the employee's estate.

The foregoing tax benefits increase the desirability of these plans as a part of the employee compensation scheme. Qualified plans permit the employer to minimize cost while maximizing employee compensation.

Qualification

The requirements of federal law, regulations of the Department of Labor, and the rulings thereunder are a maze of intricate rules with myriad exceptions, definitions, inclusions, and exclusions—all designed to describe the **qualification** procedure and standards of profit sharing and pension plans. The purpose of the plan, amounts of benefits, participation, entitlement to benefits, operation, contributions, and reporting must be structured in accordance with the statutory rules.

Few rules of life have changed as frequently as the rules regarding qualified profit sharing and pension plans. The Internal Revenue Code has been modified hundreds of times in an attempt to balance the interests of the employer and the employee in providing tax-advantaged compensation plans that are fair, effective, and legitimate. Frequently, the rules will be modified on a prospective basis to encourage employment of certain classes of persons, such as persons over or under a certain age, persons with underemployed talents, persons involved in certain industries or professions, and so on. The rules that follow are general rules that may have changed or become subject to exceptions by the time you read them, but they generally illustrate the approach of the tax qualification procedures and the requirements necessary for qualified plans.

A qualified plan must be adopted for the purpose of offering the employees a share of the profits or income of the employer or for providing a fund that will be distributed to the employees or their beneficiaries after retirement. The plan must be established and maintained by the employer for the exclusive benefit of the employees. The funds cannot be diverted for any use other than the specified purposes.

The plan may not be qualified if it is intended to benefit only a few select employees. Section 401(a) of the Internal Revenue Code is extremely forceful in insisting that the qualified plan may not discriminate in favor of employees who are officers, shareholders, or highly compensated employees. Generally, the contributions to the plan should be allocated in proportion to and benefits awarded in relation to the total current compensation of the participants of the plan. It is possible to base contributions and benefits on less than all compensation of the employees as long as the plan remains nondiscriminatory.

Participation in the plan depends upon compliance with two general statutory tests: age and service requirements, and coverage requirements.

The material in this section describes these requirements, discusses how **vesting** affects the age and service requirements, outlines certain limitations on contributions to qualified plans, and explains the formalities associated with establishing a qualified plan.

Age and Service Requirements Concerning the minimum age and service conditions, the qualified plan must permit participation for employees who have completed at least 1 year of service with the employer or who have reached age 21, whichever is later. One year of

service means a 12-month period during which the employee works at least 1,000 hours. A part-time employee who works for more than a year but only logs 18 hours a week can be safely excluded under a qualified plan. But a full-time employee who works 40 hours a week and takes a 25-week vacation must be permitted to participate (unless the vacation turns out to be permanent and the vesting rules permit a forfeiture for the terminated employee). If the plan provides that benefits will not be subject to forfeiture, or vested, immediately for employees who participate, an employer may provide for an eligibility waiting period (such as 2 years after employment begins). Older employees cannot be excluded from the plan simply because of age unless the plan is a defined (or target) benefit plan and an employee begins employment within 5 years of the normal retirement age specified in the plan. This last rule permits an employer to hire an employee who is near retirement without having to contribute large sums to the plan to provide the defined benefit amount when the employee retires during the next 5 years.

Coverage Requirements The rules for participation of certain classes of employees in a qualified plan are even more involved. Generally, a plan must pass one of four tests: a percentage test, a fair-cross-section test, a ratio test, or an average benefits test.

The **percentage test** requires that the plan cover either

1. 70% or more of all employees; or
2. 80% or more of all eligible employees, provided 70% or more of all employees are eligible.

The **fair-cross-section test** permits the plan to cover a classification of employees that is determined by the Internal Revenue Service not to be discriminatory in favor of officers, shareholders, or highly compensated employees. The test anticipates that the Internal Revenue Service will review the employees who are covered, make a determination that the plan is fair and not discriminatory, and approve the plan for qualification.

The **ratio test** compares highly compensated employees against non-highly compensated employees. The percentage of non-highly compensated employees covered must be at least 70% of the percentage of highly compensated employees covered by the plan.

The **average benefits test** combines the fair-cross-section test and the ratio test. The plan may benefit certain employees under a classification that the Internal Revenue Service has determined does not discriminate, and the average benefit percentage for non-highly compensated employees must be at least 70% of the average benefit for highly compensated employees.

A complex illustration may serve to explain these otherwise simple rules. Suppose a corporation has 80 regular employees who work full-time, and 5 part-time employees who work less than 1,000 hours in a 12-month period. The 80 regular employees may be classified as follows:

Age	<i>Served over 5 Years</i>	<i>Served 3–5 Years</i>	<i>Served 1–3 Years</i>	<i>Served Less Than 12 Months</i>
Over 60	7	2		
21–60	42	7	5	1
Under 21	<u>3</u>	<u>4</u>	<u>2</u>	<u>7</u>
	52	13	7	8

First, a determination is made regarding who will be potentially excludable under the age and service rules. The plan may exclude the 5 part-time employees, because they work too few hours, and may exclude the 8 full-time employees who have served less than 12 months. The other 9 full-time employees who have not reached age 21 may be excluded. The plan also could exclude the 2 employees who are over 60 and who have served less than 5 years, but only if they began their employment when they were older than a specified age (say 60), *and* if the normal age of retirement is not more than 5 years older (say 65), *and* if the plan is a defined benefit plan where benefits are set in a certain amount after retirement and the employer would have to rapidly contribute great quantities of money for these employees in order to meet those benefits upon retirement.

As for coverage, the percentage test requires that a qualified plan must cover 70% of *all* employees or 80% or more of all *eligible* employees, provided 70% or more of all employees are eligible. In this case the plan must cover at least 56 employees (based upon 70% of all employees). It has already been determined that the plan excludes the 5 part-time employees, the 8 full-time employees who do not meet minimum service requirements, and the 9 full-time employees who are under age 21. This leaves 63 employees who meet the minimum age and service requirements (adequate to meet the 70% test). Under the second part of the percentage test, the plan also could be qualified if only 80% of all eligible employees are covered, as long as 70% of all employees are eligible. Thus, since 63 employees are eligible, as few as 51 (80% of those eligible) could be covered and the plan would still qualify for tax advantages.

If the plan provided that only employees who earned more than \$30,000 per year would be included as participants, and if only 40 employees qualified under that test, the plan would not be qualified under the first part of the percentage test because of the participation formula rules. However, the plan might qualify under the fair-cross-section test if the Internal Revenue Service determines that even though only 40 employees are covered, the plan does not discriminate in favor of officers, shareholders, or highly compensated employees. This decision would require a determination that enough employees make substantially more than \$30,000 per year that the threshold salary does not meet the “highly compensated” standard.

Suppose the corporation adopts a plan designed to cover only employees who work in a specified place, and only 20 employees meet that test. All is not lost even though the plan dismally fails the percentage test. The plan could still obtain special approval of the Internal Revenue Service if it is found not to be discriminatory in favor of officers, shareholders, or highly compensated employees. However, if the service learned that the “specified place” is corporate headquarters where management offices are located, the special classification would not be likely to succeed.

Try another example. Suppose the 80 regular employees are further classified as follows:

	<i>Highly Compensated Employees</i>	<i>Non-Highly Compensated Employees</i>
Eligible Employees	13	46
Noneligible Employees	4	17
Ratio of Eligible to Noneligible Employees	76%	73%

Using the ratio test, the plan would be qualified with the proportions of the employees specified in the table, since the non-highly compensated employees covered must be at least 70% of the highly compensated employees covered by the plan. Seventy-six percent of the highly compensated employees are eligible, and 73% of the non-highly compensated employees are eligible. This is a 96% ratio (70% to 73%).

The average benefits test compares the average benefits paid to non-highly compensated employees with the average benefits paid to highly compensated employees, based upon a classification approved by the Internal Revenue Service. Again in this case, the Internal Revenue Service reviews the average benefits paid to the respective groups and makes a determination whether the plan discriminates in favor of the highly compensated employees.

One final question to test the reader’s keen awareness of these rules: Could the corporation qualify a plan that covered only the 63 employees who work full-time, are over 21 years of age, and have worked at least 3 full years with the corporation? The answer is, yes. The plan meets the 70% test. Minimum age and service requirements are also met *if* the plan provides for immediate vesting.

Vesting Vesting is the employer’s incentive hammer. As long as the benefits under the plan have not vested, the employer can reasonably expect that the employee will continue to work for the employer, hoping to enjoy vesting of the benefits one day. If the benefits have vested, the employee is absolutely entitled to them, and the incentive to remain with the company may be diminished. Consequently, most employers prefer to defer vesting as long as possible. The

vesting schedules state the *maximum* periods of time the plans may defer vesting and still be qualified.

The qualified plan may meet one of two alternative vesting schedules under section 411 of the Internal Revenue Code. The first alternative is called **five-year cliff vesting**. The plan may provide that no benefits will vest until five years of service have been completed, and then the benefits must be 100% vested and nonforfeitable. Under the second alternative, the plan may provide for three- to seven-year vesting. The employee may be required to complete at least three years before any benefits become vested. At the end of three years, 20% of the benefits vest, and each year 20% more of the benefits vest until the seventh year, when the benefits are 100% vested and nonforfeitable.

Limitations on Contributions Section 415 of the Internal Revenue Code places certain limitations on the benefits and contributions to qualified plans that must be strictly observed. A defined benefit plan is generally limited to the lesser of \$90,000 or 100% of the participant's average compensation for his or her highest three years. This \$90,000 is adjusted for cost-of-living increases by the Treasury Department annually, and the limitation is also modified depending upon the age and years of service for each employee. The defined contribution plan is limited to the lesser of \$30,000 or 25% of the participant's compensation for the annual contribution to the plan. This amount is also adjusted for cost-of-living increases, and employee contributions are taken into account in making the computation.

Formalities The statutory formalities demand that the plan be permanent, in writing, and communicated to the employees. Its terms must contemplate a continuing program of contributions by the employer and distributions to the employees. Although the plan may be terminated for business exigencies not within the employer's control, termination is always subject to careful scrutiny by the Internal Revenue Service to determine whether the plan was truly intended to be continuous at inception. Thus, there must be a valid business reason, unforeseeable when the plan was adopted, for the plan to be terminated. The written plan may be distributed to the employees; or, at least, a pamphlet describing the salient provisions of the plan should be available to the employees.

Finally, the operation of the plan is an important element to its qualification. The plan must be funded. The **funding** arrangements may be accomplished by a trust, requiring contributions from the employer to an institutional trustee, who invests the funds and distributes them in accordance with the trust agreement. The funds also may be used to purchase insurance contracts or other investment contracts for the benefit of the employee plan. In sum, there must be a formal contribution and investment arrangement, distinguishable from normal corporate activities by contractual provisions, preferably with an independent third party, to operate and administer the plan.²⁶

INCENTIVE STOCK OPTIONS

Stock options that are offered as additional employee compensation may perform an incentive function with tax advantages. However, rather than monetary remuneration, a stock option is designed to give the optionee-employee an ownership interest in the corporation-employer (the optionor).

A stock option is a written instrument in which a corporation offers the right to purchase stock in the corporation to an individual at a predetermined price at any time during a stated period. The individual is under no obligation to accept the offer to purchase. As you may expect, to benefit the recipient, the option offers the stock to the optionee at a price other than the market price. This feature has considerable incentive value, much as the carrot in front of the donkey does. The price is set at an amount higher than market price at first, encouraging the employee to produce profits so the market price will rise above the option price, at which time the employee will have the option to purchase the stock at the discount option price. The in-

centive factor continues even after the employee exercises the option, since the value of the stock purchased should increase as the profits of the granting corporation increase.

An employee compensated by stock options should be motivated to work very hard on behalf of the corporation, since the employee will eventually profit by holding the option until the market value of the stock exceeds the option price. By exercising the option, the employee makes a discount purchase of the stock and becomes a shareholder who has a pecuniary interest in the corporation's performance. Moreover, by using stock options, the corporation is compensating an employee without incurring any immediate expense, because the issuance of an option requires no direct payment to the employee. The ownership interest of existing shareholders is affected by stock options, since the exercise of the option dilutes their proportionate ownership of the company, but if the stock option motivates employees to continually strive for profits, the existing shareholders also benefit from the resulting increase in stock values.

As a part of its compensation program, a corporation may adopt a stock option plan to benefit certain employees. Options granted under the plan give the recipients the right to purchase stock of the corporation at a specified price, the **option price**, for a specified period of time. The offer of stock to the employee may be accepted only during this period, and the act of acceptance is the exercise of the option. Upon payment of the option price to the corporation, the employee is entitled to receive certificates for the stock.

Tax Ramifications

Incentive stock options (ISOs) may receive special tax treatment under the Internal Revenue Code.²⁷ An incentive stock option is an option granted by a corporation to an individual based upon the individual's employment with the corporation.

When a corporation grants an incentive stock option to an employee, the employee does not realize any income at the time of the receipt of the option (even though the option may have value). If the corporation were to give the employee a cash payment equivalent to the value of the option, the payment would be treated as ordinary income and taxed immediately. Instead, with an incentive stock option plan, the employee will be taxed only when stock acquired through the exercise of the option is sold. This could be several years later, after the stock has substantially appreciated in value.

To obtain the benefits of an incentive stock option plan, the employee must not dispose of the stock for at least two years from the date the option was granted, and the employee must hold the stock for at least one year after purchasing it through the option. (These periods do not apply if the employee dies.) The employee also must remain employed by the corporation from the time the option is granted until three months before the option's exercise. These factors explain why these plans are regarded as incentive plans, since the employee must stay employed in order to realize the benefit of the stock option, the stock purchased, and the tax consequences.

When stock is purchased under an incentive stock option plan, the amount by which the fair market value of the stock at the time the option is exercised exceeds the option price is an item of **tax preference**. Tax preference income is subject to a surtax of an additional percentage. This additional tax does not constitute an onerous burden on most employees, since the tax preference surtax is charged only against employees who receive substantial benefits from the exercise of the option. To illustrate, consider Shelley Roberts, an employee of the Nobles Company, who has an option to buy 1,000 shares of corporate stock at \$10 per share. When she exercises the option, the market price of the stock is \$50 per share. In that year, she has tax preference income of \$40,000, the difference between the market value and the option price. Further suppose that Shelley's tax preference income is taxed at 15%. The tax preference surtax is \$6,000 in the year the option is exercised. If she holds the stock for more than three years, and sells it at \$60 per share, her gain is \$50,000, since she purchased the stock at \$10 per share. The tax preference surtax does not diminish the desirability of the incentive stock option as a form of compensation. Shelley will have paid \$6,000 in extra tax in the hypothetical transaction, but she also has profited \$50,000. Who would complain about that?

Qualification

The Internal Revenue Code specifies several requirements for the qualification of tax-favored incentive stock option plans,²⁸ and like qualified pension and profit sharing plans, the incentive stock option plan must accord strictly with the statutory rules. Generally, these requirements are concerned with the adoption and content of the option plan, the duration of the plan, the exercise of the option, the option price, and the employees covered by the plan.

An incentive stock option plan must state the number of shares that may be issued under the plan, and must describe the classes of employees who are eligible to receive options. The identification of shares to be issued under the plan should include the description of the shares from the articles of incorporation. The number may be specific, or a formula may be prescribed to establish the total number of shares that may be issued under the plan.

EXAMPLE

Shares Subject to the Plan

The Committee, from time to time, may provide for the option and sale in the aggregate of up to 100,000 shares of Common Stock of the Company. Shares shall be made available from authorized and unissued or reacquired Common Stock.

For the tax benefits of the qualified stock option to be enjoyed, the option must be granted to a person employed at the time of the grant. Individuals who are employed by a parent or subsidiary corporation of the granting corporation would qualify, but a prospective employee would not. Moreover, the optionee must remain an employee at all times during the period from the date the option is granted to three months before the date the option is exercised. The continuous employment requirement does not apply to a deceased employee, but is strictly observed in all other cases. The plan may include this limitation in its provisions.

EXAMPLE

Rights in Event of Termination of Employment

In the event of termination of employment for any cause other than death, a participant's option shall expire within three months after his or her employment terminates. Nothing contained in the Plan shall confer upon any participant any right to be continued in the employ of the Company or any subsidiary of the Company or shall prevent the Company or any subsidiary from terminating the participant's employment at any time, with or without cause.

It is possible to state in the plan that the stock options granted under the plan will expire immediately upon termination of employment; the Internal Revenue Code simply provides that the option may not extend beyond three months after termination to qualify for the advantageous tax treatment. The estate of a deceased employee is not so limited unless the option specifically so provides, and it may.

EXAMPLE

Rights in the Event of Death

In the event of the death of a participant while in the employ of the Company or a subsidiary, or within three months after termination of such employment, the option theretofore granted the participant shall be exercisable, in whole or in part, within the next three months succeeding the participant's death, if and to the extent the participant could have exercised it at the date of his or her death, by such person as shall have acquired the right to exercise such option by will or by the laws of descent and distribution.

The identification of employees covered by the plan may be satisfied by reasonably specific descriptions—for example, “supervisory employees,” “all salaried employees,” or “all employees of the corporation.” The board of directors, or its delegates, usually has the power to determine the number of shares to be optioned to each employee within those described in the plan. Employees who own 10% or more of the voting stock of the corporation immediately before the option is granted are ineligible, unless the option price is at least 110% of the fair market value of the stock at the time the option is granted and the option terms require that the option must be exercised within a five-year period.

Participants

The Committee shall determine and designate from time to time those key employees (including employees who are also officers or directors) of the Company and its subsidiaries (as defined in section 425(f) of the Internal Revenue Code of 1986, as amended) to whom options are granted and who thereby become participants in the Plan. In selecting the individuals to whom options shall be granted, as well as in determining the number of shares subject to each option, the Committee shall weigh the positions and responsibilities of the individuals being considered, the nature of their services, their present and potential contributions to the success of the Company, and such other factors as the Committee shall deem relevant to accomplish the purpose of the Plan. No option shall be granted to an employee who, immediately before such option is granted, owns stock possessing more than 10 percent of the total combined voting power or value of all classes of stock of the Company or its subsidiaries. Each grant of an option shall be evidenced by an option agreement which shall contain such terms and conditions as may be approved by the Committee and shall be signed by an officer of the Company and the employee.

EXAMPLE

An incentive stock option plan must be approved by the stockholders of the granting corporation within twelve months before or after the date the plan is adopted. A plan is usually adopted by an appropriate resolution of the board of directors.

Resolution to Adopt a Qualified Stock Option Plan

WHEREAS, it is the belief of the Board of Directors of this Corporation that its key employees would be interested in acquiring a part of the capital stock of this Corporation, and that ownership of stock of this Corporation by its key employees would be to the advantage of this Corporation, and

WHEREAS, by the recent increase in capital stock of this Corporation, there is available for further subscriptions a total of one hundred thousand (100,000) shares of the common stock of this Corporation,

BE IT RESOLVED, That the Board of Directors do hereby adopt the Incentive Stock Option Plan, a copy of which is made a part of this resolution, subject to the approval of the common stockholders at their next regular meeting, and

RESOLVED FURTHER, That the Board of Directors of this Corporation do hereby recommend to the stockholders that they authorize the Board of Directors to set aside a total of ten thousand (10,000) shares of the common stock of this Corporation for sale to its key employees under said Incentive Stock Option Plan.

EXAMPLE

The date of the resolution adopting the plan will be the date used to determine whether shareholder approval has been obtained within the statutory period. The required shareholder approval may come within twelve months before or after the adoption of the plan by the board of directors. Consequently, the shareholder action may be the impetus that causes the board to adopt a plan. As long as shareholder approval and board adoption occur within a twelve-month period, the plan may be qualified.

The federal tax law requires only that the plan be approved by the affirmative vote of the holders of the majority of the voting stock of the corporation. The vote is taken at a regular or special stockholders' meeting, and the normal shareholder voting provisions of the state

corporate statute apply.²⁹ Further, there may be other requirements for shareholder action in the statute, articles of incorporation, or bylaws to obtain a waiver of any preemptive rights in the stock issued under the option. Shareholder approval of the plan must comply with those requirements.

An incentive stock option must be granted within ten years from the date on which the plan is adopted or the date on which the plan is approved by stockholders, whichever is earlier. Accordingly, the plan should contain an expiration date within the ten-year period. The expiration of the plan has no effect upon any options previously granted pursuant to the plan's terms.

EXAMPLE

Termination

The Plan shall terminate ten years after its effective date, or on such earlier date as the Board of Directors may determine.

The option may not be exercised after the expiration of ten years from the date it is granted. The plan should so state, and each option should recite a specified period for exercise within this limitation.

EXAMPLE

Option Period

The term of each option shall be such period as the Committee may determine, but not more than ten years from the date the option is granted.

Some quick mathematics should reveal that the period from first grant to last exercise under any qualified stock option plan may not exceed twenty years. If an option were granted just before the expiration of the ten-year period following adoption and shareholder approval of the plan, it would remain exercisable for ten additional years. Thus, the last option may be exercised almost twenty years after the plan takes effect.

The option price may not be less than the fair market value of the stock on the date the option is granted for the plan to qualify for special tax treatment. Thus, the employee can benefit only from the appreciation in the value of the stock following the grant of the option. This feature increases the incentive value of the option, since the employee's performance will be directed toward increasing the market value of the stock over the option price. The tax benefits of an incentive stock option are lost if the option price is less than the market price when the option is granted.

The determination of the option price is generally the responsibility of the board of directors or its appointed committee, and only a general statement regarding option price need be included in the option plan. It is absolutely necessary to specify that the option price will be not less than the market value of the stock on the date the option is granted. If the stock subject to the option has a par value, the option price also must be at least par value.

EXAMPLE

Option Price

Shares of Common Stock of the Company shall be offered from time to time at a price to be determined by the Stock Option Committee, which price shall be not less than the fair market value of the stock on the day the option is granted.

Fair market value shall be the mean between the highest and lowest selling prices on the New York Stock Exchange on the valuation date. If there are no sales on such date, the value shall be determined by taking the mean between the highest and lowest sales upon the last preceding date on which such sales occurred. In no event shall the option price be less than the par value.

The remaining statutory requirements for qualification limit the employee-shareholder's ability to exercise other outstanding options, the ability to transfer the option to others, and the percentage ownership interest in the corporation and its affiliated corporations. The first rule is that an option may not be exercisable while there is outstanding an employee stock option previously granted to the same employee. This rule prevents the successive issuance of options at lower amounts when the market value of the company's stock is declining. The plan should recognize this limitation in its terms.

Prior Options

EXAMPLE

A subsequent option may not be exercised by a participant while that participant has outstanding any other prior stock options under this or prior stock option plans that entitle him or her to purchase stock of the same class in the Company at a price higher than the option price of such subsequent option.

The Internal Revenue Code also states that an incentive stock option may not be transferable by the employee—it may be exercised only by that employee. The singular exception to this rule is that transfers are permitted upon the death of the employee by the employee's will or by the laws of descent and distribution. The terms of the option should so state.

Nonassignability

EXAMPLE

Options are not transferable otherwise than by will or the laws of descent and distribution, and are exercisable during a participant's lifetime only by the participant.

Finally, the Internal Revenue Service frequently places various limitations on the amount of stock that may be subject to the option. Sometimes it states those limitations in terms of a **grant limitation**, so that an incentive stock option plan will not qualify if an employee is granted incentive stock options in excess of a certain amount (e.g., \$100,000) in a calendar year. Sometimes those limitations are stated in terms of **exercise limitations**, so that an employee may not exercise incentive stock options in excess of a certain amount (e.g., \$100,000) in any calendar year. Any limitations in the Internal Revenue Code must be observed. When a limitation is changed, the prior limitation usually applies for all options granted while the prior limitation was in effect, and the new limitations apply only to options granted thereafter. Sometimes the machinations of the Internal Revenue Service can be a significant advantage to an employee. For example, an employee who is granted an option for \$100,000 of stock in 1996 (when grant limitations applied) and is also granted an option for an additional \$100,000 of stock in 2004 (when exercise limitations applied) may be able to purchase \$200,000 of stock in 2004, since both the grant and exercise limitation rules for the applicable options are met.

Administration of the Plan

The terms of the plan will describe the persons who are to administer it. The board of directors can serve in this capacity, but it may delegate administration authority to a committee appointed by the board. The terms of the plan should prescribe a procedure for the administrators' actions, and the authority granted or restricted in the administration of the plan.

Administration

EXAMPLE

The Plan shall be administered by a Stock Option Committee (herein called the Committee) consisting of three or more members of the Board of Directors of the Company who are not eligible to receive options under the Plan or who have waived their rights to receive options during such time as they are members of the Committee. The Committee shall be appointed annually by the Board of Directors, which may from time to time appoint additional members of the Committee or remove members and appoint new members in substitution for those previously appointed and fill vacancies however caused. A majority of

EXAMPLE

the Committee shall constitute a quorum and the acts of a majority of the members present at any meeting at which a quorum is present, or acts approved in writing by all of the members, shall be deemed the action of the Committee. Subject to the provisions of the Plan, the Committee is authorized to interpret it; to prescribe, amend, and rescind rules and regulations relating to it; and to make all other determinations necessary or advisable for its administration. It is intended that all options granted under the Plan be “incentive stock options” under the Internal Revenue Code of 1986, as amended.

EXAMPLE**Allotment of Shares**

The Committee shall determine the number of shares to be offered from time to time to each participant except that the maximum number of shares offered to any one participant upon the initial offering at the inception of the Plan shall not exceed 2,000 shares, and the maximum number of shares that any participant may purchase pursuant to the initial offering and all subsequent offerings under the Plan shall not exceed 5,000 shares. The Committee also may prescribe a minimum number of shares that may be purchased at any one time, and the time or times shares will be issued pursuant to the exercise of options. In any offering after the initial offering, the Committee may offer available shares to new participants or to then participants or to a greater or lesser number of participants, and may include previous participants in accordance with such determination as the Committee shall make from time to time.

The administrators should have authority to adjust the provisions of the option to account for subsequent capital adjustments in the corporation. For example, a stock split or stock dividend will reduce the market price, and may cause the option price to be unrealistic. An adjustment to the option will preserve its viability.

EXAMPLE**Adjustment upon Changes in Capitalization**

In the event there is any change in the Common Stock of the Company by reason of stock dividends, stock split-ups, recapitalization, reorganizations, mergers, consolidations, combinations or exchanges of shares, or otherwise, the number of shares available for option and the shares subject to any option shall be appropriately adjusted by the Committee.

The plan should carefully limit the authority of the administration to modify its terms. If an amendment to the plan violates any of the statutory requirements for qualification, the qualified status of the plan and the options granted under it will be lost, and the tax benefits will be eliminated. Consequently, only technical amendments should be permitted, and the authority to amend should prohibit the types of changes that would result in a substantive modification affecting qualification.

EXAMPLE**Amendment**

The Board of Directors may at any time suspend, rescind, or terminate the Plan and may amend it from time to time in such respects as it may deem advisable, provided, however, that no such amendment shall, without further approval of the stockholders of the Company, except as provided herein, (a) increase the aggregate number of shares as to which options may be granted under the Plan either to all individuals or any one individual; (b) change the minimum option purchase price; (c) increase the maximum period during which options may be exercised; (d) extend the termination date of the plan; or (e) permit the granting of options to members of the Committee. No option may be granted during any suspension of the Plan or after the Plan has been rescinded or terminated, and no amendment, rescission, suspension, or termination shall, without the participant’s consent, alter or impair any of the rights or obligations under any option theretofore granted to that participant under the Plan.

In granting a stock option, the corporation is offering to issue securities that may have to be registered under federal and state securities laws. If the securities have been registered, the corporation should have no problem issuing the stock under the option. However, if the securities are not registered, it is important to obtain a representation from the employees that the stock is being purchased only for investment and not for distribution and resale to the general public. The sale of securities to key employees may be exempt from the registration requirements of the securities laws, but severe penalties are prescribed for sale of unregistered stock to the general public. The representation by the employee not to resell to the public is designed to protect against these liabilities. The plan may contain a clause acknowledging the purpose of the purchase.

Purchase for Investment

EXAMPLE

All stock of the company purchased pursuant to any option must be purchased for investment and not with the view to the distribution or resale thereof. Each option will be granted on the understanding that any shares purchased thereunder will be so purchased, and each employee to whom an option is granted shall be required to deliver to the company a written representation and agreement to that effect.

Finally, the plan should recite the requirements of payment and other consideration to be given by the employee for the receipt and the exercise of the option. The plan may exact a promise from the employee that the employee will remain employed with the company for a period of time as a condition to the privilege of receiving the option.

Consideration for Option

EXAMPLE

Each participant shall, as consideration for the grant of the option, agree to remain in the continuous employ of the Company or one or more of its subsidiaries for at least two years from the date of the grant of such option.

Payment for Stock

EXAMPLE

Full payment for shares purchased shall be made at the time of exercising an option in whole or in part. No shares shall be issued until full payment therefor has been made, and a participant shall have none of the rights of a stockholder until shares are issued to him or her.

LIFE INSURANCE PROGRAMS

Various programs of life insurance coverage are available to a corporation for the benefit of its employees. Some of these programs have unique income tax advantages under the Internal Revenue Code, and all of them are intended to benefit the beneficiaries of an employee upon the employee's death with little or no cost to the employer.

Death benefit compensation programs are frequently used by corporations. Typically, the employer will promise to pay a portion of the employee's salary to the heirs for a period of time after death in consideration of the employee's continuous faithful performance. The corporation will normally apply for life insurance on the employee to cover this contingent liability, and will use the proceeds of the insurance to pay the agreed amounts to the heirs. For the employee, a death benefit agreement is like an insurance policy for the family, and the insurance is completely without cost to the employee.

Split-dollar insurance is another common plan used to benefit key personnel. The corporation and the employee join in the purchase of a life insurance policy on the life of the

employee, and the employer-corporation pays a share of the premium, usually equal to the annual increase in the cash value of the policy. The employee pays the remaining premium. The corporation is named beneficiary to receive the amount of the premiums it has paid, and the employee will designate a beneficiary for the balance. When the employee dies, the corporation receives a return of all premiums paid, and the employee's beneficiary receives the remaining face value of the policy. The advantage to the employee is that the beneficiary will receive a considerable sum while the employee's share of the premiums has been minimal. The corporation will recover all it has paid and will have no out-of-pocket costs to provide the insurance benefit.³⁰

EMPLOYEE EXPENSE REIMBURSEMENT PLANS

Many companies have instituted self-insured plans for employees as a method of supplementing group hospital insurance plans, major medical insurance, and other forms of reimbursement that may be provided to all employees. The variety of employee benefit plans is limited only by the imagination and generosity of the employer. Employers provide free transportation, buffet lunches, health and athletic club memberships, and a variety of other **expense reimbursement** provisions that encourage employees to remain loyal and dedicated to their work.

The Internal Revenue Code recognizes certain statutory benefit plans that provide reimbursement of expenses to employees, and permit tax benefits for the company for payment on the plans. These plans include accident and health plans, qualified group legal services plans, educational assistance programs, dependent care assistance programs and cafeteria plans, where the employee may select the particular benefit he or she desires.

Comprehensive nondiscrimination rules are applied to benefit plans for which there are tax advantages. These rules generally are designed to avoid a "top heavy" plan that provides benefits to only highly compensated employees to the exclusion of other employees. For a plan to provide tax-free benefits, it must meet certain tests to determine whether participation in the plan is permitted on a nondiscriminatory basis, whether the benefits received from the plan are provided on a nondiscriminatory basis, and whether the plan is valid. While similar in intent, the rules are different from the nondiscrimination rules relating to pension and profit sharing plans.³¹

Administration of the Plan

These employee plans and the nondiscrimination provisions that apply to them are administered by companies specializing in employee benefit administration. Rarely does the lawyer or paralegal become involved in making the necessary computations and applying the eligibility or benefit rules to determine if the plan will achieve the tax-advantaged objectives. The primary task of legal counsel is to draft a plan that complies with the statutory rules and regulations and requires compliance in the future with the various nondiscrimination provisions.

Drafting a Valid Plan

To avoid taxation of employer-provided benefits, the company must adopt a plan that meets at least five requirements:

1. the plan must be in writing;
2. the plan must provide employees with reasonable notification of benefits available under the plan;
3. the plan must be maintained for the exclusive benefit of employees, or spouses and dependents of employees where permissible;
4. the employee's rights under the plan must be legally enforceable (which means that benefits under the plan may not be discretionary with the employer); and
5. the employer must have intended to maintain the plan indefinitely when the plan was established.

The following checklist should be followed for preparation of a plan.

Checklist

1. An introduction to the plan should recite the plan's purpose, the plan's effective date, and the manner in which the plan will be administered.

Purpose, Effective Date, and Administration

MEDICAL AND DENTAL EXPENSE REIMBURSEMENT PLAN (the "Plan") has been established by Sickness and Health, Inc., a corporation (the "employer"), to provide for reimbursement of certain medical and dental expenses incurred by its eligible employees and their dependents.

Effective Date

The "effective date" of the Plan is July 1, 2005. The Plan year shall be the calendar year.

Administration of the Plan

The Plan will be administered by the employer. Any documents required to be filed with the employer will be given or filed properly if delivered or mailed by registered mail, postage prepaid, to the employer at 7561 South Cedar Street, Atlanta, Georgia.

EXAMPLE

2. The membership should be defined in accordance with the rules against discrimination.

Membership

Each employee of the employer will become a member in the Plan on the effective date, or on the first day of any calendar month during which the employee meets all of the following eligibility requirements, if such employee is not employed or does not meet such requirements, on the effective date:

- a) The employee is customarily employed by the employer on a full time (customarily fifteen (15) hours or more per week) and permanent (customarily five (5) months or more per calendar year) basis;
- b) The employee has attained the age of twenty-one (21); and
- c) The employee has completed six (6) months of service with the employer. However, if the employer has not been in existence for such period upon meeting the other requirements hereof, then the employee shall qualify if such employee has been employed for the lesser period in which the employer has been in existence.

EXAMPLE

3. The plan benefits should be stated, with a maximum dollar limit.

Plan Benefits

Subject to the conditions and limitations of the Plan, each calendar year, beginning on the effective date, each member will be entitled to reimbursement from the employer of the medical care costs (as defined herein) incurred during that year with respect to that member's family unit (as defined herein) to the extent that such costs do not exceed an amount equal to the lesser of:

- a) the total medical care costs of the family unit paid during that calendar year; or
- b) \$10,000.

EXAMPLE

4. A definition of medical care costs should be included.

Medical Care Costs

The term "medical care costs" as used in the Plan means amounts paid by a member (or any other individual included in that member's family unit) for:

- a) diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body;
- b) transportation primarily for and essential to medical care referred to in subparagraph (a) above;
- c) insurance covering medical care referred to in subparagraphs (a) and (b) above; and
- d) any other amounts paid that are included within the meaning of "medical care" as defined in section 213 of the Internal Revenue Code of 1986, or any comparable provision of any future legislation that amends, supplements, or supersedes that section.

EXAMPLE

5. The beneficiaries under the plan should be defined.

EXAMPLE**Family Unit**

The term “family unit” as applied to any member means the member, the member’s spouse, and such other persons as are dependents within the meaning of section 152 of the Internal Revenue Code of 1986, or any comparable provision of any future legislation that amends, supplements, or supersedes that section.

6. The manner of making payments under the plan should be described.

EXAMPLE**Manner of Making Payments**

By the end of each calendar year or within thirty (30) days thereafter, the employer shall reimburse each member for the portion of the member’s family unit’s medical care costs incurred during the year that is payable to that member, provided that by the end of that year or within thirty (30) days thereafter, the employer receives evidence acceptable to it that such medical care costs have been paid by the member or any other individual included in the member’s family unit.

7. Provisions should be recited to avoid duplication of payments for the same expenses.

EXAMPLE**Nonduplication of Benefits**

A member shall not be reimbursed for medical care costs under this Plan to the extent that such costs are paid to or for the benefit of the member, or to or for the benefit of any other individual included in the member’s family unit, under the provisions of any public plan of health insurance or under the provisions of any other plan or insurance policy, the costs or premiums of which are directly or indirectly paid, in whole or part, by the employer.

8. If the employer is to pay all of the benefits under the plan, that should be stated.

EXAMPLE**Financing Plan Benefits**

Subject to the provisions of [Amendment and Termination], the employer expects and intends to pay the entire cost of the benefits provided by this Plan. No member will be required or permitted to make contributions under the Plan.

9. The items required by the employer to document the charges should be described.

EXAMPLE**Information to Be Furnished by Members**

Members must furnish to the employer such documents, evidence, data, or information as the employer considers necessary or desirable for the purpose of administering the Plan or for the employer’s protection. The benefits of the Plan for each member are on the condition that the member furnish full, true, and complete data, evidence, or other information, and that the member will promptly sign any documents related to the Plan requested by the employer.

10. Any implication that the plan provides a continuing right of employment should be eliminated.

Employee Rights

The Plan does not constitute a contract of employment, and participation in the Plan will not give any member the right to be retained in the employ of the employer, nor will participation in the Plan give any member any right or claim to any benefit under the Plan, unless such right or claim has specifically accrued under the terms of the Plan.

EXAMPLE

11. Someone (usually the employer) should be able to interpret the plan, with that person’s decision being final.

Provision That Employer’s Decision Is Final

Any interpretation of the Plan and any decision on any matter within the discretion of the employer made by the employer in good faith is binding on all persons. A misstatement or other mistake of fact shall be corrected when it becomes known, and the employer shall make such adjustments on account thereof as it considers equitable and practicable.

EXAMPLE

12. Provisions for terminated participating employees should be included.

Benefits of Terminated Participating Employees

If a member’s employment by the employer is terminated by reason of the member’s resignation or dismissal, then any amount payable to that member under the Plan immediately prior to the member’s termination shall be paid to the member. If a member’s participation in the Plan is terminated by reason of the member’s death, then any amount that has become payable to the member under the Plan as of the date of his or her death shall, in the discretion of the employer, be paid to either the member’s spouse or the member’s estate.

EXAMPLE

13. Amendment and termination provisions should describe the manner in which an amendment occurs, the causes of termination, and provisions for notice of either.

Amendment and Termination

General. While the employer expects to continue the Plan, it must necessarily reserve and does reserve the right to amend the Plan from time to time or to terminate the Plan.

Amendment. If the employer exercises its right to amend the Plan, any amount that has become payable under the Plan to any person prior to the date on which such amendment is adopted shall be paid by the employer in accordance with the terms of the Plan in effect prior to that date.

Termination. The Plan will terminate on the first to occur of the following:

- a) the date it is terminated by the employer;
- b) the date the employer is judicially declared bankrupt or insolvent; or
- c) the dissolution, merger, consolidation, or reorganization of the employer, or the sale by the employer of all or substantially all of its assets, except that in any such event arrangements may be made whereby the Plan will be continued by any successor to the employer or by any purchaser of all or substantially all of the employer’s assets, in which case the successor or purchaser will be substituted for the employer under the Plan.

If the Plan is terminated in accordance with subparagraph (a) or (c) above, any amount that has become payable under the Plan to any person prior to the date of termination shall be paid by the employer in accordance with the terms of the Plan in effect prior to its termination.

Notice of Amendment or Termination. Members will be notified of an amendment or termination within a reasonable time.

EXAMPLE

Variations on Employee Retirement Plans

Individual Retirement Accounts An individual income earner may establish his or her own plan for retirement using an Individual Retirement Account (IRA). The individual establishes an account with a bank or financial institution into which he or she makes contributions that are deductible from the individual's taxable income in the year of contribution. An individual may use an IRA only if he or she is not covered under any other qualified plan. The deductibility of income decreases as one's income grows and is eventually phased out completely over a certain threshold of income. Penalties will be imposed if the funds are withdrawn before the individual reaches age 59½ and the funds are taxed when they are distributed. Distributions must be made before the individual reaches age 70½.

SEP-IRA Self-employed individuals may adopt a Simplified Employee Pension (SEP) plan to make annual contributions for retirement up to the lesser of 15% of the individual's compensation or a ceiling amount (e.g., \$30,000). If the self-employed individual employs other persons, such as an assistant or a paralegal, contributions may be made to this SEP plan by them as well. The contributions are tax deductible and the earnings in the account will not be taxed until the funds are withdrawn. A penalty will be imposed if the funds are withdrawn before the individual reaches age 59½, and the funds are taxed when they are distributed. Distributions must be made before the individual reaches age 70½.

Roth IRA A variation on this theme of Individual Retirement Accounts is the Roth IRA, which permits contributions of funds to a retirement account from income that has already been subject to income tax. The amount of the contributions to a Roth IRA are not deductible, so the employee must pay tax on the income before contributing funds to this account. However, earnings on investments made in the account will not be taxed, and distributions after the employee has reached age 59½ are not taxable. These funds do not have to be withdrawn when an individual reaches age 70½, allowing the account to be retained as part of the individual's estate for his or her heirs. There are limitations on the individuals who are entitled to use a Roth IRA. Generally, persons earning more than a specified ceiling of taxable income (e.g., \$110,000 for a single individual) are not eligible for this plan.

SIMPLE A SIMPLE (Savings Incentive Match Plan for Employees) is a plan that can be used by small employers to begin a retirement program for employees. The plan is usually structured as an Individual Retirement Account into which employees may contribute an amount of their annual income. A SIMPLE-IRA allows the employee to contribute more than would ordinarily be allowed to be contributed by an Individual Retirement Account (See Exhibit 12-2, Form 5304-SIMPLE).

401(k) Plans Section 401(k) of the Internal Revenue Code provides for retirement plans that consist mostly of contributions by the employees that are tax advantaged for purposes of saving for retirement. These plans are favored by smaller companies because they allow for annual employee contributions (up to a certain threshold amount) in an account set aside as a 401(k) account. The employee contributions may be made from deductions from the employee's compensation and are not taxed at the time the compensation is paid. The employer may contribute up to the amount contributed by the employee. The amount saved in the 401(k) account may be invested by the plan administrator or sponsor. The profits earned on those investments are not taxed until the money is withdrawn, when the employee is retiring and in a lower individual income tax bracket. Contributions that were made by the employer may not be withdrawn unless the employee reaches age 59½, is disabled, suffers some hardship, or retires. If an employee changes his or her place of employment, the 401(k) account can be brought to the new employer and continued.

Exhibit 12-2.

Form 5304-SIMPLE

Form 5304-SIMPLE (Rev. March 2002) Department of the Treasury Internal Revenue Service	Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use With a Designated Financial Institution	OMB No. 1543-1502 Do not file with the Internal Revenue Service
--	---	--

_____ establishes the following SIMPLE IRA plan under section 408(p) of the Internal Revenue Code and pursuant to the instructions contained in this form.

Name of Employer _____

Article i—Employee Eligibility Requirements (complete applicable box(es) and blanks—see instructions)

1 General Eligibility Requirements. The Employer agrees to permit salary reduction contributions to be made in each calendar year to the SIMPLE IRA established by each employee who meets the following requirements (select either 1a or 1b):

a Full Eligibility. All employees are eligible.

b Limited Eligibility. Eligibility is limited to employees who are described in both (i) and (ii) below:

(i) Current compensation. Employees who are reasonably expected to receive at least \$ _____ in compensation (not to exceed \$5,000) for the calendar year.

(ii) Prior compensation. Employees who have received at least \$ _____ in compensation (not to exceed \$5,000) during any _____ calendar year(s) (insert 0, 1, or 2) preceding the calendar year.

2 Excludable Employees.

The Employer elects to exclude employees covered under a collective bargaining agreement for which retirement benefits were the subject of good faith bargaining. **Note: This box is deemed checked if the Employer maintains a qualified plan covering only such employees.**

Article ii—Salary Reduction Agreements (complete the box and blank, if applicable—see instructions)

1 Salary Reduction Election. An eligible employee may make an election to have his or her compensation for each pay period reduced. The total amount of the reduction in the employee's compensation for a calendar year cannot exceed the applicable amount for that year.

2 Timing of Salary Reduction Elections

a For a calendar year, an eligible employee may make or modify a salary reduction election during the 60-day period immediately preceding January 1 of that year. However, for the year in which the employee becomes eligible to make salary reduction contributions, the period during which the employee may make or modify the election is a 60-day period that includes either the date the employee becomes eligible or the day before.

b In addition to the election periods in 2a, eligible employees may make salary reduction elections or modify prior elections _____ if the Employer chooses. If the Employer chooses this option, insert a period or periods (e.g., semi-annually, quarterly, monthly, or daily) that will apply uniformly to all eligible employees.

c No salary reduction election may apply to compensation that an employee received, or had a right to immediately receive, before execution of the salary reduction election.

d An employee may terminate a salary reduction election at any time during the calendar year. If this box is checked, an employee who terminates a salary reduction election not in accordance with 2b may not resume salary reduction contributions during the calendar year.

Article iii—Contributions (complete the blank, if applicable—see instructions)

1 Salary Reduction Contributions. The amount by which the employee agrees to reduce his or her compensation will be contributed by the Employer to the employee's SIMPLE IRA.

2a Matching Contributions

(i) For each calendar year, the Employer will contribute a matching contribution to each eligible employee's SIMPLE IRA equal to the employee's salary reduction contributions up to a limit of 3% of the employee's compensation for the calendar year.

(ii) The Employer may reduce the 3% limit for the calendar year in (i) only if:

(1) The limit is not reduced below 1%; (2) The limit is not reduced for more than 2 calendar years during the 5-year period ending with the calendar year the reduction is effective; and (3) Each employee is notified of the reduced limit within a reasonable period of time before the employees' 60-day election period for the calendar year (described in Article II, item 2a).

b Nonelective Contributions

(i) For any calendar year, instead of making matching contributions, the Employer may make nonelective contributions equal to 2% of compensation for the calendar year to the SIMPLE IRA of each eligible employee who has at least \$ _____ (not more than \$5,000) in compensation for the calendar year. No more than \$200,000* in compensation can be taken into account in determining the nonelective contribution for each eligible employee.

(ii) For any calendar year, the Employer may make 2% nonelective contributions instead of matching contributions only if:

(1) Each eligible employee is notified that a 2% nonelective contribution will be made instead of a matching contribution; and

(2) This notification is provided within a reasonable period of time before the employees' 60-day election period for the calendar year (described in Article II, item 2a).

3 Time and Manner of Contributions

a The Employer will make the salary reduction contributions (described in 1 above) for each eligible employee to the SIMPLE IRA established at the financial institution selected by that employee no later than 30 days after the end of the month in which the money is withheld from the employee's pay. See instructions.

b The Employer will make the matching or nonelective contributions (described in 2a and 2b above) for each eligible employee to the SIMPLE IRA established at the financial institution selected by that employee no later than the due date for filing the Employer's tax return, including extensions, for the taxable year that includes the last day of the calendar year for which the contributions are made.

* For 2003 and later years, this amount is subject to annual cost-of-living adjustments. The IRS announces the increase, if any, in a news release, in the Internal Revenue Bulletin, and on the IRS's internet web site at www.irs.gov.

For Paperwork Reduction Act Notice, see page 6. Cat. No. 23377W Form 5304-SIMPLE (Rev. 3-2002)

Exhibit 12–2.

(continued)

Page 2

Form 5304-SIMPLE (Rev. 3-2002)

Article IV—Other Requirements and Provisions

- 1 **Contributions in General.** The Employer will make no contributions to the SIMPLE IRAs other than salary reduction contributions (described in Article III, Item 1) and matching or nonelective contributions (described in Article III, items 2a and 2b).
- 2 **Vesting Requirements.** All contributions made under this SIMPLE IRA plan are fully vested and nonforfeitable.
- 3 **No Withdrawal Restrictions.** The Employer may not require the employee to retain any portion of the contributions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions.
- 4 **Selection of IRA Trustee.** The employer must permit each eligible employee to select the financial institution that will serve as the trustee, custodian, or issuer of the SIMPLE IRA to which the employer will make all contributions on behalf of that employee.
- 5 **Amendments To This SIMPLE IRA Plan.** This SIMPLE IRA plan may not be amended except to modify the entries inserted in the blanks or boxes provided in Articles I, II, III, VI, and VII.
- 6 **Effects Of Withdrawals and Rollovers**
 - a An amount withdrawn from the SIMPLE IRA is generally includible in gross income. However, a SIMPLE IRA balance may be rolled over or transferred on a tax-free basis to another IRA designed solely to hold funds under a SIMPLE IRA plan. In addition, an individual may roll over or transfer his or her SIMPLE IRA balance to any IRA after a 2-year period has expired since the individual first participated in any SIMPLE IRA plan of the Employer. Any rollover or transfer must comply with the requirements under section 408.
 - b If an individual withdraws an amount from a SIMPLE IRA during the 2-year period beginning when the individual first participated in any SIMPLE IRA plan of the Employer and the amount is subject to the additional tax on early distributions under section 72(t), this additional tax is increased from 10% to 25%.

Article V—Definitions

- 1 **Compensation**
 - a **General Definition of Compensation.** Compensation means the sum of the wages, tips, and other compensation from the Employer subject to federal income tax withholding (as described in section 6051(a)(3)) and the employee's salary reduction contributions made under this plan, and, if applicable, elective deferrals under a section 401(k) plan, a SARSEP, or a section 403(b) annuity contract and compensation deferred under a section 457 plan required to be reported by the Employer on Form W-2 (as described in section 6051(a)(8)).
 - b **Compensation for Self-Employed Individuals.** For self-employed individuals, compensation means the net earnings from self-employment determined under section 1402(a), without regard to section 1402(c)(6), prior to subtracting any contributions made pursuant to this plan on behalf of the individual.
- 2 **Employee.** Employee means a common-law employee of the Employer. The term employee also includes a self-employed individual and a leased employee described in section 414(n) but does not include a nonresident alien who received no earned income from the Employer that constitutes income from sources within the United States.
- 3 **Eligible Employee.** An eligible employee means an employee who satisfies the conditions in Article I, item 1 and is not excluded under Article I, item 2.
- 4 **SIMPLE IRA.** A SIMPLE IRA is an individual retirement account described in section 408(a), or an individual retirement annuity described in section 408(b), to which the only contributions that can be made are contributions under a SIMPLE IRA plan and rollovers or transfers from another SIMPLE IRA.

Article VI—Procedures for Withdrawal (The employer will provide each employee with the procedures for withdrawals of contributions received by the financial institution selected by that employee, and that financial institution's name and address (by attaching that information or inserting it in the space below) unless: (1) that financial institution's procedures are unavailable, or (2) that financial institution provides the procedures directly to the employee. See *Employee Notification* on page 5.)

Article VII—Effective Date

This SIMPLE IRA plan is effective _____ . See instructions.

Name of Employer _____	By: _____	Signature _____	Date _____
Address of Employer _____	Name and title _____		

Form 5304-SIMPLE (Rev. 3-2002)

KEY TERMS

employment at will
 exempt employees
 nonexempt employees
 comp time
 key employee
 employment agreement/contract
 compensation

salary
 current incentive program
 commission
 draws against compensation
 bonus plan
 renewal provision
 severance compensation

golden parachute provision
 employee handbook/manual
 implied covenant of good faith and fair dealing
 Employment Retirement Income Security Act (ERISA)
 restrictive or proprietary covenant

trade secrets	constructive receipt	funding of plan
work product protection clause	pension plan	stock option, incentive stock option
nondisclosure agreement	profit sharing plan	option price
liquidated damage clause	qualification of plan	tax preference
covenant not to compete,	vesting	grant limitation
noncompetition agreement	percentage test	exercise limitation
severability provision	fair-cross-section test	death benefit compensation program
group incentive plan	ratio test	split-dollar insurance
deferred compensation plan	average benefits test	employee expense reimbursement plan
forfeiture clause	five-year cliff vesting	Revenue Act of 1978

WEB RESOURCES

For research on federal and state minimum wage laws and the Fair Labor Standards Act, access

[<http://www.dol.gov>](http://www.dol.gov)

Employment resources at federal and state levels, including business laws and regulatory assistance and complete texts of the current federal regulations may be obtained from

[<http://www.sba.org>](http://www.sba.org)
[<http://www.access.gpo.gov>](http://www.access.gpo.gov)
[<http://www.osha.gov>](http://www.osha.gov)

Forms for incentive compensation plans are available from

[<http://www.techagreements.com>](http://www.techagreements.com)

Forms for SIMPLE Plans are available from

[<http://www.irs.ustreas.gov>](http://www.irs.ustreas.gov)

Information concerning Employee Retirement Income Security Act (ERISA) filings, IRS approved rollovers, public pension funds, administrative providers, tax exempt organizations, SEC filings, and other useful information about tax-deferred plans and programs is available at

[<http://www.freerisa.com>](http://www.freerisa.com)

Form employment agreements, employment manuals and handbooks, and other employer-employee related notices and documents are available free or at a moderate cost from

[<http://www.lawdepot.com>](http://www.lawdepot.com)
[<http://www.uslegalforms.com>](http://www.uslegalforms.com)
[<http://www.easyemploymentagreements.com>](http://www.easyemploymentagreements.com)
[<http://www.vcaonline.com>](http://www.vcaonline.com)
[<http://www.techagreements.com>](http://www.techagreements.com)
[<http://www.weblawresources.com>](http://www.weblawresources.com)



CASES

CLAY v. ADVANCED COMPUTER APPLICATIONS, INC.

536 A.2d 1375 (Pa. Super. 1988)

MONTEMURO, JUDGE

Appellants, Jeffrey Clay and Mary Clay, challenge the dismissal of their claims against appellees, Bjorn J. Gruenwald and Richard Baus. We affirm in part and reverse in part the order of the Bucks County Court of Common Pleas.

The Clays filed this action to recover damages for wrongful discharge, breach of an implied contract of em-

ployment and intentional infliction of emotional distress. In their complaint, they alleged that Bjorn Gruenwald had terminated their employment with Advanced Computer Applications, Inc. solely because Mary Clay had rebuffed the sexual advances of Richard Baus, a management-level employee. The complaint named as defendants (1) Advanced Computer; (2) Bjorn J. Gruenwald, both individually and as president of Advanced Computer, and (3) Richard Baus.

* * *

In support of their breach of contract claim, the Clays alleged that Advanced Computer hired them “on a regular full time basis for the purpose of long-term employment and career advancement.” The Clays also allege that they “accepted the positions offered” and “ceased . . . looking for other gainful employment” in reliance upon “oral statements of the Defendant corporation.” More specifically,

they claimed that several months after they began working for Advanced Computer they informed Mr. Gruenwald of their plan to purchase a new home. Mr. Gruenwald, according to the Clays, not only encouraged the purchase but represented that “there were no problems with job security.” The Clays insist that these facts are sufficient to show an “implied in fact” employment contract. They apparently believe that this “contract” overcomes the presumption of at-will employment. We disagree.

Pennsylvania courts have long recognized the rule that an employer may discharge his or her employees at any time for any or no reason, absent a statutory or contractual provision to the contrary. [Citations omitted]

* * *

Although we have questioned the viability of this belief given the more regulated environment of modern employment relationships, we have repeatedly reaffirmed the at-will rule in recent years. [Citations omitted] The rule has become so thoroughly woven into the fabric of our law and our commerce that only a legislative mandate will completely abolish it. [Citations omitted]

Nevertheless, as with any hoary principle of law, the at-will rule has spawned judicial exceptions. The discharged employee can now seek relief through an action in tort for wrongful discharge. A discharge is “wrongful” when it transgresses a clearly-articulable public policy or when the employer intends to harm the employee. [Citations omitted] In addition to the wrongful discharge action, the employee can, as always, defeat the at-will presumption by establishing that he or she contracted for an employment other than one terminable at will. Courts in our sister states increasingly have recognized that this kind of contract can arise from such sources as employee handbooks. [Citations omitted] This court, however, has repeatedly refused to recognize contractual modification of the at-will rule absent a clear expression of the parties’ intent. [Citations omitted] The need for clarity is not unique to at-will employment cases. A party who wishes to enforce a contract

must plead every element of that contract specifically, and clarity is particularly important when the alleged contract is oral. [Citations omitted] We cannot give legal significance to vague promises or to statements that reflect only the aspirations or hopes of the employer, whether written or spoken. The ordinary language of friendship and collegiality should not usually bind the speaker or writer as an enforceable obligation. In this case, none of the words or actions that the Clays attribute to their former employer even approach a clear impression of intent to contract away the at-will rule.

* * *

Purchasing a new home and foregoing other employment opportunities are detriments that “all manner of salaried professionals” incur in reliance upon their employment. The facts alleged by the Clays simply do not suggest that they “brought to the employment so substantial a benefit, or incurred so detrimental a hardship in taking the job, that [they] should be accorded treatment any different from the typical at-will employee.”

Even if the Clays somehow did plead the necessary elements to prove a contract of definite duration, they have failed to allege any facts that would render either Mr. Gruenwald or Mr. Baus liable for breach. In fact, the complaint indicates that the Clays “were hired by the Defendant corporation.” It also indicates that the Clays relied upon representations of “the Defendant corporation” when they “ceased looking for other gainful employment” and that they informed “the corporation,” through its president Mr. Gruenwald, of their intent to buy a new home. The Clays nowhere allege that either Mr. Gruenwald or Mr. Baus was party to the employment agreement between the Clays and Advanced Computer. If neither Mr. Gruenwald nor Mr. Baus entered into the contract with the Clays, they could not have breached that contract.

[The Court found that the Clays could not recover for breach of an implied employment contract.]

WORTH v. HUNTINGTON BANCSHARES, INC.

540 N.E.2d 249 (Ohio 1989)

WRIGHT, JUSTICE

In February 1981, appellant, Paul E. Worth, commenced employment as Assistant Vice President with the Energy Division of Union Commerce Bank (“UCB”), a wholly owned subsidiary of Union Commerce Corporation (“UCC”). In June of that year appellee, Huntington Bancshares, Inc. (“Huntington”), contacted UCC officials and expressed an interest in combining the two bank holding

companies’ systems. When UCC declined the invitation, Huntington began acquiring stock in UCC, and by December 1981 it owned approximately five percent of UCC’s voting stock.

In response to Huntington’s proposed takeover attempt, UCC executed several employment agreements of the type commonly known as “golden parachutes” with several key employees, including Worth. Worth’s employment agreement, the pertinent parts of which are fully set forth below, provided that in the event of a change of control of UCC, Worth would be entitled to resign within two years and receive certain economic benefits if he in good faith believed

that his status or responsibilities had diminished following the takeover. The agreement also provided that Worth would be entitled to recover attorney fees incurred in defense of the agreement's validity, and that UCC would establish an irrevocable standby letter of credit of \$500,000 for such fees. The enforceability of this provision for indemnification of legal expenses was upheld in an earlier decision of this court. *Worth v. Aetna Cas. & Sur. Co.* (1987), 32 Ohio St.3d 238, 513 N.E.2d 253. Huntington subsequently completed its acquisition of UCC, having obtained more than fifty percent of the stock therein by November 1982. The UCC chairman, chief executive officer, and some directors were replaced, and the name of UCB was changed to Huntington Bank of Northeast Ohio ("HBNO"). UCC was merged into Huntington and ceased to exist as a separate entity.

Worth continued in the employ of HBNO until May 31, 1983, at which time he exercised his option under the employment agreement and resigned. Huntington refused to pay Worth the economic benefits provided therein, and on July 22, 1983, Worth brought this action to enforce the agreement.

* * *

Section 2 listed numerous benefits to which Worth would be entitled if his employment were terminated involuntarily within one year following a change in control. These benefits included two times his annual salary, payable in monthly installments over a two-year period; two times the amount he was to receive under the company's Incentive Compensation Plan; comprehensive medical coverage for two years, or the cost thereof; payment for two years of club dues and special assessments; monthly payments for rental of an automobile; lump-sum cash payment for purchase of an annuity, or the benefits to which he has a vested right under the company's pension plan; and the option to surrender his stock to the company for cash.

Section 3 of the agreement provided as follows:

"3. Resignation Within Two Years. In the event that Employee should determine in good faith that his status or responsibilities with the Company or UCB has or have diminished subsequent to a change in control, and shall for that reason resign from his employment with the Company or UCB within two years after such change in control, Employee shall be entitled to receive all of the payments and enjoy all of the benefits specified in Section 2 hereof."

* * *

This case presents the court with its first opportunity to address the enforceability of corporate employment agreements commonly known as "golden parachutes." In general, "golden parachutes" are defined as "agreements between a corporation and its top officers which guarantee those officers continued employment, payment of a lump sum, or other benefits in the event of a change of corporate owner-

ship." *Schreiber v. Burlington Northern, Inc.* (1985), 472 U.S. 1, 3, fn. 2, 105 S.Ct. 2458, 2460, fn. 2, 86 L.Ed.2d 1.

Much has been written about this form of agreement, principally as to its use as a defense against hostile takeovers. See 2 Winter, Stumpf & Hawkins, *Shark Repellants and Golden Parachutes: A Handbook for the Practitioner* (1985) 432, fn. 1. Proponents of such contracts identify at least three primary benefits: (1) attraction and retention of competent managerial personnel, (2) promotion of executive objectivity by ensuring continued financial security, and (3) effective deterrence of hostile takeover attempts. Opponents argue that these potential benefits are illusory, and that golden parachutes operate solely for the benefit of executives and at the expense of shareholders. [Citations omitted]

Recent decisions contain numerous arguments against the enforceability of golden parachute agreements, including: (1) that such contracts are void as against public policy; (2) that they are unenforceable for lack of consideration; (3) that the benefits provided are penalties and not valid liquidated damages; and (4) that such contracts bear the taint of a conflict of interest in favor of the managerial beneficiaries and to the detriment of shareholders. In some early cases courts reached a decision on procedural issues, such as standing, without reaching the merits of these arguments. [Citations omitted] However, in a few recent cases where the merits have been considered, golden parachute agreements have been upheld. [Citations omitted]

Since these agreements will vary greatly, we can make no broad pronouncement as to their validity other than to say that an agreement such as the one executed by UCC and Worth is most certainly not void as against public policy. A corporation's decision to enter into a golden parachute agreement is, like all other matters dealing with compensation of corporate executives, within the sound discretion of the corporation's board of directors. The court of appeals here specifically found that Worth's agreement was neither excessive nor tainted by executive self-dealing or conflict of interest. [Citations omitted] We see nothing in the record to cause us to disturb these findings. It is certainly not for this court to second-guess the business judgment of corporate executives. Thus we hold that an agreement between a corporation and its officer which guarantees to the officer continued employment or economic benefits following a change in corporate ownership is not void as against public policy. Accordingly, we hold that the employment agreement at issue is valid and enforceable.

* * *

The real crux of Worth's argument lies in his claim that the court should have completely deferred to Worth's subjective determination that his status and responsibilities had diminished and that he resigned for that reason. The fact that the contract provided certain benefits upon

Worth's "good faith" determination required the trial court to examine the subjective bases of Worth's decisions. However, this does not require the court to ignore evidence which conflicts with Worth's claimed reasoning. In some situations lack of good faith is synonymous with "bad faith," a term more frequently defined. However, this is certainly not true in all situations. See, *e.g.*, *Kalain v. Smith* (1986), 25 Ohio St.3d 157, 159, 25 OBR 201, 202–203, 495 N.E.2d 572, 574 (construing R.C. 1343.03[C] and holding that, "A party may have 'failed to make a good faith effort to settle' even when he has not acted in bad faith."). Moreover, in all cases a "good faith determination" requires at least to some extent that the determination be informed. Where a contract provides that entitlement to benefits thereunder is contingent on a party's good faith determination, a court reviewing that party's good faith determination should consider not only the party's subjective reasoning but also the facts and circumstances surrounding the determination. An individual claiming to make a good faith decision cannot ignore the surrounding circumstances which ought to bear on that decision. Here, there is ample evidence to support the conclusion reached below that Worth's purported reasons

for determining that his status and responsibilities had diminished were both speculative and uninformed.

In any event, the trial court's conclusion that Worth resigned for reasons other than a determination that his status had diminished is amply supported by the record. The evidence reveals several other reasons for the resignation: (1) a desire to leave the banking industry; (2) a desire to return to Massachusetts and commence an energy consulting business; and (3) a recognition that his continued employment with HBNO would no longer be guaranteed under Section 2 of his employment agreement, as the one-year protection provided therein was to end shortly after the day he tendered his resignation. The trial court's findings in this regard are supported by competent, credible evidence, and we will not overturn these findings.

Accordingly, we conclude that, because Worth did not resign because he in good faith determined that his status and responsibilities had diminished following the takeover, Worth was not entitled to the benefits provided in paragraphs two and three of his employment agreement.

* * *

PROBLEMS

1. Oswald Manufacturing Company has 250 employees, including 40 persons who are shareholders owning more than 5% of the company's stock or who earned more than \$80,000 during last year. The company's benefit package for its employees is valued at \$1,000,000 per year, \$450,000 of which apply to the 40 owner/executive employees. Does the company meet the nondiscriminatory benefits requirements of the Internal Revenue Code for its benefit program?
2. The employee's work product (i.e., inventions) should be protected while the proprietary interest of the employer is being perfected (e.g., patented) by
 - a. a consent to an injunction against the employee in the agreement;
 - b. a covenant not to compete with respect to that particular invention;
 - c. an assignment agreement for the invention from the employee to the employer;
 - d. a trade secret clause covering the invention.
3. Which of the following statements are true about qualified stock option plans?
 - a. The plan must be approved by the shareholders before the option may be granted.
 - b. The grant may be conditioned upon shareholder approval within six months.
 - c. The shareholders may approve the plan within twelve months either side of the board of directors' adoption of the plan.
 - d. none of the above
 - e. a and b but not c
 - f. a and c but not b
4. Assume you are representing the employee in negotiating an employment contract. Select the clause that would be most beneficial to the employee in the duties section of the agreement:
 - a. Employee's duties shall be such as are from time to time assigned by the company.
 - b. Employee's duties shall be strictly limited to those duties specified in this agreement.
 - c. Employee's duties shall include those duties that are reasonable and consistent with the other duties specified in this agreement.
5. Assume you are representing the employer in negotiating the employment contract. Select the clause in question 4 that would be most beneficial to the employer.

PRACTICE ASSIGNMENTS

1. Write an employment agreement for your last job *from your employer's point of view*. Include a specific description of your duties, any restriction upon your authority, and clauses that your employer probably would have desired to govern your employment relationship.
2. Prepare a memorandum concerning the relevant issues in drafting clauses in employment contracts for the following benefits:
 - a. access to a day care center;
 - b. college tuition program;
 - c. reimbursement of medical expenses for executive personnel;
 - d. incentive compensation for senior managers based upon their areas of responsibility;
 - e. disability salary continuation policy; and
 - f. a profit sharing plan for a business with young, entrepreneurial employees.
3. Timberline Lumber Company would like to negotiate an employment contract with its employee-manager. Draft the agreement, making certain that the following important particulars are covered.
 - a. Compensation will be on a salary with some incentive feature.
 - b. The duties should be sufficiently broad to allow the employee-manager to do anything for the business.
 - c. The contract should be terminable if the store fails to gross \$10,000 for four consecutive months.
 - d. The employee-manager should have an expense allowance.
 - e. Provide for a noncompetition clause (5 years, radius of 500 miles from your city).
4. Prepare an incentive stock option plan that will qualify with the Internal Revenue Service.

ENDNOTES

1. For an extensive discussion of the law relating to human resource practices and employment law see J. Paddock, *Employment Law and Practice*, West 1998.
2. Worker Adjustment and Retraining Notification Act, 29 U.S.C.A. §§ 2101–2109.
3. 42 U.S.C.A. §§2000e, et seq.
4. 29 U.S.C.A. § 206(d).
5. 29 U.S.C.A. §§ 621–34.
6. 42 U.S.C.A. § 12102.
7. Civil Rights Act of 1991, 29 C.F.R. § 1604.11.
8. Fair Labor Standards Act, 29 U.S.C. §§ 201–219.
9. Pregnancy Discrimination Act of 1978, 42 U.S.C.A. § 2000e(k).
10. Protection of Juror's Employment Act, 28 U.S.C. § 1875.
11. 38 U.S.C. §§ 4301-07; §§ 28-3-506, 28-3-609–611.
12. Family and Medical Leave Act, 29 C.F.R. § 825.303.
13. See *Johnson v. National Beef Packing Co.*, 220 Kan. 52, 4551 P.2d 779 (1976); *Wooley v. Hoffmann-LaRoche, Inc.*, 99 N.J. 284, 491 A.2d 1257, *modified* 101 N.J. 10, 499 A.2d 515 (1985); *Toussaint v. Blue Cross & Blue Shield*, 408 Mich. 579, 292 N.W. 2d 880 (1980); see Shaw and Rosenthal, *Employment Law Deskbook*, Lexis/Nexis (1989 Supp. 2003).
14. *Pine River State Bank v. Mettill*, 333 N.W. 2d 622, 626 (Minn. 1983).
15. See "Employee Expense Reimbursement Plans" later in this chapter.
16. E.g., Cal. Bus. & Prof. Code §§ 16600–02 (West).
17. See Colo. Rev. Stat. § 8-2-113; Fla. Stat. Ann. § 542.33 (West); S.D. Codified Laws Ann. § 53-9-8.
18. See "Employment Agreements" earlier in this chapter.
19. See "Deferred Compensation" later in this chapter.
20. Forms for incentive compensation plans can be obtained from <<http://www.techagreements.com>>.
21. Internal Revenue Code (hereafter I.R.C.) of 1986, 26 U.S.C.A. § 401.
22. I.R.C. of 1986, 26 U.S.C.A. § 401.
23. I.R.C. of 1986, 26 U.S.C.A. § 404.
24. I.R.C. of 1986, 26 U.S.C.A. §§ 401, 501.
25. I.R.C. of 1986, 26 U.S.C.A. § 402.
26. Several firms act as administrators of pension and profit sharing plans. A list of administrators may be found at <<http://www.freeerisa.com>>.
27. I.R.C. of 1986, 26 U.S.C.A. § 422.
28. I.R.C. of 1986, 26 U.S.C.A. § 422.
29. The Model Business Corporation Act and most states require the affirmative vote of the holders of a majority of the voting stock to approve such action. See M.B.C.A. § 7.25; "Shareholders Meetings—Voting of Shares" in Chapter 10.
30. The tax treatment of split-dollar arrangements has recently been modified by the Internal Revenue Service. The arrangement may be treated either as (1) a loan by the employer to the employee for the amount of the premiums paid by the employer or (2) a taxable benefit to the executive equal to the cost of the insurance plus the net cash value available to the executive.
31. Nontaxable Insurance, Health, and Fringe Benefit Plans are authorized generally in the I.R.C. of 1986 §§ 101–140. Each section contains particular eligibility, participation, and coverage requirements for qualified plans, and should be reviewed for the current requirements.