

Moving Beyond the Start-Up: Key Concerns of Founders during Transition

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When a company moves beyond the start-up phase, its founders and founding employees may or may not have an on-going leadership role to play; and whatever role founders and founding employees have in the maturing company, it is unlikely to be as broad as during the start-up phase. Worse, many founders and founding employees have been victim to oppressive conduct by venture capital-controlled Boards that has rendered founders' investments – of money, ideas and labor - valueless. See Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 North Carolina Journal of Law & Technology 223 (2005) (suggesting that Massachusetts precedent and/or the Delaware "entire fairness doctrine" will form the basis of a new wave of oppression claims under Delaware and Massachusetts law); see also *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578 (1975) (establishing rights of minority shareholders in closely held corporations).

As a company matures, and even before, its founders should take steps to protect their own interests and those of founding employees to whom they are loyal.

I. An Ounce of Prevention – Employment Agreements

Separate legal counsel should be retained as early as possible to ensure that founders and founding employees are adequately protected, as investors, inventors and employees. Founder, and those of the founding employees whom they wish to protect, should have written employment agreements, negotiated at arms-length. As a company matures, these agreements may be re-negotiated to meet the needs of the maturing company but having these agreements in place ensures that founders and founding employees have some protection from oppressive conduct that might render their equity stake in the company's future value-less.

The general commercial covenant of good faith and fair dealing applies to the terms of written employment agreements, even if the employment is at will; and such covenant requires that "neither party shall do anything that will have the effect of destroying or injuring the rights of the other party to receive the fruits of the contract." See *Williams v. B & K Medical Systems, Inc.*, 49 Mass App. Ct 562, 569 (2000).

Such agreements should include the following:

- Title, authority and, as appropriate, Board participation;
- Compensation (current, deferred and equity);
- Ownership of intellectual property;
- Scope of any non-competition and non-solicitation clauses;
- Change of control protection; and

- Termination and separation pay.

A. Title, Authority and Board Participation

As a company matures, founders are often asked to step back in favor of a more seasoned managerial team. In many companies, however, founders continue to have important roles, e.g., as Chief Science Officers, Chief Marketing Officers, or members of the Board of Directors. These new roles should be clarified and confirmed *in writing* before or during each round of financing so that there is no misunderstanding as to what the founders' roles will be post-financing.

B. Compensation

During the start-up phase, many founders and founding employees accept below market current compensation with the expectation that their efforts will be rewarded if the company is successful. These expectations have been fueled by the prevalence of equity plans that provided an often illusory "stake" in the start-up's future – often because the at will employment doctrine makes vesting unlikely if not impossible, because the options are under-water during the post-termination exercise period, or because of oppressive financing arrangements discussed in *Burned Angels*. Therefore, founders and founding employees should request deferred compensation arrangements that will reward them for their efforts, even if they are involuntarily terminated so long as the termination is not for "good cause." "Cause" often includes intentional malfeasance materially affecting the company as well as conviction of a felony involving fraud or deceit. However, it may also include an intentional refusal to comply with the lawful directives of the Board, material violations of the agreement itself, and material violations of certain company policies, and the like.

As to what may constitute good cause absent a clearly defined contractual term, Massachusetts law provides that an employer must exercise honesty and good faith, *see, e.g., Fried v. Sungs*, 242 Mass. 527, 531 (1922); and the question of satisfactory performance is a question of fact for the jury. *See Boothby v. Texon, Inc.*, 414 Mass. 468, 481 (1993). For example, "one holding a position of responsibility ... is not bound to as strict adherence to directions of supervisors as one in an employment involving the exercise of less responsibility and discretion." *See Mansfield v. Lang*, 293 Mass. 386, 395-396 (1936). Likewise, neither a mere personality conflict nor a disagreement over one's own contractual rights will necessarily constitute cause. *Hammond v. T.J. Little & Co.*, 82 F.3d 1166, 1176-1175 (1st Cir. 1996).

New Internal Revenue Code Section 409A and the regulations to be promulgated there under govern the structure of non-qualified deferred compensation plans, e.g., an arrangement in which service is provided in one tax year but compensation is paid in a later tax year. In the executive compensation field, non-qualified deferred compensation arrangements shield executive compensation from current taxation but such arrangements may also be used to protect founders' and founding employees' long-term expectations.

For example, even if the company cannot afford to pay founders and founding employees' current compensation at market rate, the company can provide a multi-year bonus plan that pays out over time as certain targets are met. Such bonus plans often pay lump sums in the event of a change in control or an involuntary termination.

These deferred compensation arrangements, unlike equity plans, insure that founders and founding employees receive the benefit of the bargain they struck with the start-up - even if their equity stake is unvested at time of termination, worthless during the post-termination exercise period, or drastically diluted after one or several rounds of financing. Much attention is being paid to

these deferred compensation plans as a result of the passage and implementation of Section 409A, and now is the time to extend their protections to founders and founding employees.

C. Restrictive Covenants

At the time of incorporation, corporate counsel should advise founders to obtain their own counsel regarding transfer of intellectual property and other restrictive covenant agreements, e.g., trade secret agreements, non-competes and non-solicit agreements. Those agreements should be narrowly drafted, in both depth and scope. For example, biochemist founders should be careful to transfer to the start up only the IP that is relevant to the particular drug the start-up is developing, not all possible drugs that the biochemist founders may conceive while employed by the start-up. Likewise, sales professional founders should be careful not to agree to broadly worded non-solicit agreements that bar their soliciting, or even accepting, work from former customers, whether or not the work is competitive.

Even if some of these agreements are arguably “unenforceable,” which many lay people believe, founders’ equity rights are often contingent on compliance with these agreements; and these agreements can be a barrier to new employment or the funding of new ventures. The mere fact that such overly-broad agreements exist puts founders at a disadvantage if they are dissatisfied with their lot in the maturing company and wish to negotiate a departure. Enforceable or not, relief from such agreements becomes something for which exiting founders “pay” in negotiated concessions. (Exiting founders may be willing to agree to transfers of additional IP and further competitive restrictions but those are concessions for which the maturing company should pay, not the other way around.)

D. Change of Control Protections

Change of control agreements encourage founders and founding employees to stay in place, working for the good of the company and its shareholders, even though their own jobs are at risk. Change of control protections are likely to include the following: triggers, exercise procedures, dispute resolution and, often, gross-up protections against unfavorable tax treatment.

Most change of control agreements are so-called “double trigger” agreements – the change of control must take place *and* the employment must be adversely affected. Indeed, some second triggers are really multiple triggers, requiring, for example, not just a reduction in authority, but also a reduction in compensation. It is the second trigger that is usually at issue. The parties often have contrary views regarding whether employment that is clearly “different” post change of control has been sufficiently “adversely” changed to trigger a termination and the corresponding financial payment, which is often significant. Thus, the drafting of the second trigger language is often the subject of intense negotiations.

The exercise procedures usually require some provision for notice to the company and, sometimes, opportunity for the company to cure the adverse action. Most change of control agreements expire after a year or two, and many require exercise within a certain number of months of the second trigger.

Mandatory arbitration of disputes is common in change of control agreements, often with provisions regarding the award of attorneys’ fees and costs. Provisions that are most favorable to the executive have the fees paid by the company, no matter who prevails, so long as the executive was found to have acted in “good faith” in filing for arbitration.

Finally, many change of control agreements also contain tax-related provisions addressing the possibility that the triggered payments to certain executives (“Disqualified Individuals”¹) may constitute “excess parachute payments” within the meaning of Code Section 280G. As discussed below, addressing this issue contractually is both common and critical, as the application of Section 280G can result in the imposition of a non-deductible 20% excise tax on the executive under Section 4999 of the Code (above and beyond the executive’s general tax liability) for all covered payments above the executive’s base amount,² and a loss of deduction to the Company.

In the private company setting, a mechanism exists to exempt these payments from Section 280G. Code Section 280G(b)(5)(B) generally provides that payments in the nature of compensation will not constitute “parachute payments” and will not be subject to Code Sections 280G and 4999 if (1) none of the Company’s stock is readily tradable on an established securities market or otherwise, (2) such payments are approved by a separate vote of the persons who own, *immediately* before the change of control of the corporation, more than seventy-five percent (75%) of the voting power of all outstanding stock of the corporation held by shareholders entitled to vote who will not directly benefit from such approval, and (3) prior to the vote, adequate disclosure of all material facts concerning such payments is made to all shareholders entitled to vote who will not directly benefit from the approval of the payments.

Section 1.280G-1 of the Treasury Regulations published in the Federal Register on August 4, 2003 (“the Regulations”) contain detailed and mandatory procedures and requirements to satisfy this exception, including that the shareholder approval must determine the covered executive’s right to receive the payment or, if the executive has already received the payment, the right to retain the payment. It is insufficient for such shareholder vote to “ratify” payments that the corporation is already unconditionally obligated to make.

These procedures present some practical difficulties. Ideally for the executive, the requisite approvals would be obtained when he or she enters into the change of control agreement. Because these agreements are often entered into well before the change of control, it may not be possible to provide adequate disclosure under the Regulations and/or the shareholder composition may change between the time of the approval and the change of control. Accordingly, to avoid the imposition of the excise tax, when the change of control is imminent, the executive may be asked to “waive” the benefit of the agreement unless the appropriate shareholders reapprove the payments after receiving the necessary disclosures. While the executive may have sufficient leverage and be sufficiently confident in the likely outcome of such a vote, as discussed below, obtaining contractual protection at the outset is certainly more desirable.

Essentially, there are three alternative approaches that are used to address Sections 280G and 4999. In descending order of preference to the executive, they are: Gross-up; Modified Cap; and 2.99 Cap. Under the first, the executive is contractually entitled to receive a “gross-up” payment with respect to any excess parachute payments, for: a) any excise tax on the initial parachute

¹ A Disqualified Individual is one who performs personal services and is an officer, shareholder, or a highly compensated employee (i.e. in the top one percent (1%) or one of the 250 highest paid employees, if lesser).

² The recipient’s average annualized includable compensation for the most recent five years before the change of control.

amount and b) income and excise tax on gross up payments themselves. The effect of the gross-up is to put the executive in the same position as he or she would have been in absent the 20% excise tax.

The second approach (modified cap) calls for the payments and benefits to the executive to be reduced to the extent necessary to avoid excise tax if doing so would result in the executive obtaining a larger after-tax amount, taking into consideration the income, excise, and employment taxes imposed on the overall payments and benefits.

The third approach, the 2.99 Cap, imposes a formula that automatically reduces payments to the extent necessary to ensure that the sum of all "parachute payments" does not exceed 2.99 times the executive's "base amount." These provisions can result in significant "cut backs" to the executive, and are particularly inequitable when the executive's base amount is not particularly high and/or he or she has a large value of accelerated options or restricted stock.

E. Termination and Separation Pay

Most start-up and maturing companies understand the many advantages of negotiated transitions, especially for high profile, well-respected founders and founding employees – e.g. actual and perceived stability, minimized disruption to employee productivity and morale, and, as discussed below, risk management regarding potential legal claims. For many reasons, including the requirements of Section 409A of the Internal Revenue Code, the parties should clarify what constitutes a termination for which founders and founding employees will receive separation pay and benefits.

If the termination is involuntary, as is usually the case, the requirements and consequences of Section 409A may not apply if the company pays the exiting founders and founding employees quickly enough for the payments to fall within one of the two applicable exceptions currently available. (Beware, however, that regulations regarding Section 409A are not yet final.)

The first exception is the "short term deferral" exception regarding which any amount of separation pay is paid no later than 2.5 months after the end of the year in which the termination took place. The second allows for separation pay to be paid over a period not extending beyond the end of the second year after the year of termination, so long as the amount is not greater than either twice the employee's total pay or, for 2006, \$440,000. Note, however, that if a founder falls within the Section 409A definition of a "specified employee", that founder will have to wait six months before taking his or her separation pay and, possibly, other termination-related benefits.

If the economic condition of the company is such that the separation pay cannot be paid quickly enough to fall within either exception noted above, compliance with Section 409A requirements is crucial. The individual taxpayer, not the company, is subject to an additional 20% tax and possible interest if Section 409A requirements are not met.

II. A Pound of Cure – Legal Claims

If no employment agreement has been put in place, founders and founding employees will look for protections elsewhere. Most founders and founding employees are minority shareholders of Delaware incorporated start-ups. As discussed in *Burned Angels*, those minority shareholders may have more rights than they realize. As also discussed in *Burned Angels*, it is unsettled whether or not Delaware will adopt the Massachusetts doctrine articulated in *Donahue* and its progeny, but the Delaware "entire fairness" doctrine provides a powerful alternative.

Under Delaware law, directors and majority shareholders owe fiduciary duties to minority shareholders, including “honesty, loyalty, good faith and fairness,” see *Singer v. Magnavox Company*, 380 A. 2d 969, 977 (1977); and when those directors and/or majority shareholders are on both sides of a transaction involving the company, they have an affirmative duty to act in the best interest of the company and of the minority shareholders. See *Guff v. Loft*, 5 A. 2d 508, 511 (1939). In such circumstance, those directors and/or majority shareholders must be able to demonstrate that the transaction meets the “entire fairness” test, i.e., that it is fair to the minority shareholders. See *Singer v. Magnavox Company*, 380 A. 2d at 976; *Weinberger v. UOP, Inc.*, 457 A. 2d, 701, 710 (1983). Furthermore, directors may not exercise their discretion for the primary purpose of perpetuating their control over the company, and those directors who eliminate dissenters carry the burden of proving that such elimination was for a proper business purpose. See *Cheff v. Mathes*, 199 A. 2d 549, 554 (1964). Where current majority investors and/or directors are also potential later round investors, they have an affirmative duty to act in the best interests of the corporation and of the minority shareholders vis-à-vis the later round funding. They also have a duty to not undermine effort to obtain other funding on terms more favorable than they or those they represent are prepared to offer. See *Guff v. Loft*, 5 A. 2d at 510. Massachusetts courts have recently demonstrated their willingness to exercise their equitable powers to prevent oppression of minority shareholders, ordering corrective remedies that are otherwise unavailable at law. See *Brodie v. Jordan*, 66 Mass. App. Ct. 371, 385 (2006).

Founders and founding employees may also rely on Massachusetts tort claims, including the following three. First, when their employment is terminated, they are voted off their Boards, and/or their shares are re-purchased not for a proper business purposes but because they refused to acquiesce to oppressive terms, because they attempted to compel directors to abide by fiduciary duties, and/or because they threatened to expose breaches of fiduciary duties, founders and founding employees may have claims for tortious interference with advantageous relations. See e.g., *Mailhot v. Liberty Bank & Trust Co.*, 42 Mass. App. Ct. 525 (1987) (termination of plaintiff motivated by defendant’s fear of exposure of own wrongful conduct is actionable). See e.g., *Bennett v. Breuil Petroleum Corp.*, 99 A. 2d 236 (1953) (conduct having as its primary purpose the “freezing out” of minority shareholder is actionable); *Cheff v. Mathes*, 199 A. 2d at 554; cf. *Wilkes v. Springside Nursing Home, Inc.* 370 Mass. 842 (1976) (termination of employment of minority shareholder actionable breach of duty owed minority shareholder); *King v. Driscoll*, 418 Mass. 576 (1994) (conduct leading to the termination of minority shareholder/employee who engaged in shareholder derivative suit actionable).

Second, Massachusetts recognizes a common law claim for wrongful termination in violation of public policy. *King v. Driscoll*, 418 Mass. 576, 582 (1994). “[A]t an at-will employee has a cause of action for wrongful termination where her termination violates a clearly established public policy, as where she is terminated for asserting a legally guaranteed right, for doing what the law requires, or for refusing to do that which the law forbids.” *Joyce v. GF/Pilgrim, Inc. d/b/a The Guardian Center*, 2003 WL 22481100, *6 (Mass. Super.) (citing *King v. Driscoll*, 418 Mass. 576, 582 (1994); *Wright v. Shriners Hosp. for Crippled Children*, 412 Mass. 469, 472 (1992)).

Third, by publishing false and derogatory reasons for a termination, the majority and/or directors, individually and in their official capacities, may have defamed founders and founding employees, and caused irreparable harm to their good names. Conditional privileges do not attach to statements made with malice (e.g., improper motive or reckless disregard for the truth). See e.g., *Ezekiel v. Jones Motor Co., Inc.*, 374 Mass. 382, 390-391 (1978) (false statements made for purpose of securing plaintiff’s discharge are not privileged); *Dragonas v. School Committee of Melrose*, 64 Mass. App. Ct. 429 (2005).