

Even CEOs Get Fired: Protecting Executives, Entrepreneurs & Employees in California

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The Problem/Conundrum/Solution

- CEOs, presidents and founders get fired all the time, especially in dynamic, deal driven Silicon Valley. What separates those suffering at the end of a professional relationship from those with leverage is what they do before it begins
- Firing – Can be good, bad, or horrible
- Economically irrational firings happen all the time
- Wrongdoer (if there is one or more) – Could be the person who stood up at the fired entrepreneur's wedding

About this Presentation

- Broad-based presentation
- Focus is on Start-Up Driven Silicon Valley
- Areas of Concern for Entrepreneurs and Executives and Their Counsel
 - Negotiating “professional prenuptial agreements” (offer letters, employment agreements, changes in control agreements and management carveout agreements).
 - Important facts, terms and conditions
 - * Capitalization Table * Liquidation Preferences * Severance packages * Equity Protection * Protecting bonuses
 - * Corporate changes in control * Squeeze outs * Terminations/demotions/diminution of responsibilities
 - * Non-Compete Clauses/Agreements
- M&A Transactions - Areas of Concerns for Management Team/Entrepreneurs/Executives
- Q&A

The Call – The Soon To Be Hired Executive

You/Me/Attorney: Hi, this is _____. How can I help you?

I.M. Silicon: Hi. My name is I.M. Silicon. I've just received a fantastic offer to be Chief Executive Officer of this great start-up. It already has \$3 million in revenue. I'm absolutely certain I can drive the company to \$25 million in revenue in 18 to 24 months and set it up for a sale or IPO. They've offered me 2.5 million shares of stock vesting over 4 years, plus a \$250,000 year salary and bonus potential of up to 100% of my salary. This is a great deal that I don't want to mess up.

You/Me/Attorney: So, why are you calling me?

I.M. Silicon: My neighbor. Our kids play soccer together. My neighbor told me I should make sure to talk with a lawyer before signing on the dotted line. I'm not sure I need a lawyer, but he's a good guy who has made a boatload in Silicon Valley, so that's why I'm calling.

I.M.'s First Concern: Capitalization Table

The Problem:

- How much is 2,500,000 shares of stock worth?
- 2,500,000 out of 5,000,000 = 50%
- 2,500,000 out of 250,000,000 = 1%

Protection:

- The equity offered represents what percentage of fully diluted capital of the Company on an as converted to common stock basis?
- Capitalization Table
- Representation in Offer Letter/Employment Agreement

IM's Second Concern: Liquidation Preferences

The Problem:

- Liquidation Preferences
- Overhang
- Preferences

Explanation of Liquidation Preferences – Preferred Stock v Employees' Common Stock

Often Hard for Executives/Entrepreneurs to Understand

- They don't always get it

Protection:

- Management Carve-out Plans (or something similar)

IM's Third Concern: Protecting Equity

The Problem: Losing Equity

At-Will Employment – What this means vis-à-vis equity

Stock Option/Restricted Stock – Vesting

- Cliff Vesting
- Pro-rata Time Based Vesting
- Performance Based Vesting

Straight Loss of All Equity

- Fired Before Vesting
- Fired for Cause
- Forfeiture Clauses

Loss of all Unvested Equity

- Termination of Employment
- Change in Control (future equity lost) – BEWARE of the operative equity plan

IM's Third Concern: Protecting Equity (cont.)

Loss of Potential Upside Liquidity Premium

- Forced Repurchase Clauses/Buy Back Clauses
- Repurchase Price Might Not Be Fair Market Value

Time to Exercise

Illiquidity

Protection:

- Acceleration Clause
 - On Termination of Employment/Change in Control
 - Partial Accelerated Vesting
 - Full Accelerated Vesting
- Extended Post-Termination Exercise Clause
- Change-in-Control Agreement/Clause

IM's Fourth Concern: Protecting the Bonus

The Problem: Losing/Not Receiving the Bonus

Types of Bonuses

- Discretionary
- Non-Discretionary
- Hybrids
- Guaranteed (usually at outset of employment for a specific length of time)

Other Types of Bonuses

Protection:

- Specific Metrics
- Set Date to Adopt Metrics
- Set Date to Earn
- Pro-Rata Payment of Bonuses
- Full Bonus Paid at Target (or similar) on Termination of Employment

Digression – Concerns Re Commissions

The Problem: Not Receiving Full Commission (The Calculation Problem)

The Problem: Getting Fired Before Commission Payment

Protection:

- Agreement When Commission is Earned
- Specific Clearly Understood Terms of Commission Plans
- The Law – Cal. Labor Code § 218.5 - Statutory Shifting of Attorneys' Fees

IM's Fifth Concern: Separation Benefits

The Problem:

- No Job, No Salary, No Benefits
- Different Job, Different Salary, Different Benefits
- At Will Employment

Protection:

- Employment Agreement as “Professional Prenuptial Agreement”
- Separation Pay
- COBRA Premium Payments
- Other Benefits

IM's Sixth Concern: Personal Due Diligence

Why is he being hired?

Why is this Company hiring a new CEO?

Interference from Board? Founder?

What are the problems with this Company?

- Has IM done his personal due diligence?
- Is the technology as good as promised?
- Is the funding/runway as good as promised?
- Will it really be ready for sale in 18 – 24 months?
- Will it really be ready for an IPO ever?

IM's Future Concerns – The M&A Transaction

The Problem: Many Potential Areas of Concern For Executive/Entrepreneur – Person & Situation Dependent

This Discussion is Truly an Hors d'oeuvres of Concerns

Four Repeat Concerns

- Employment Agreement Cramdown
- Post-Change-in-Control Life/Time Horizon
- The Non-Competition Agreement
- The M&A Agreement and Related Documents' Terms and Conditions
 - E.g. Indemnification Termination Clause
 - E.g. Release Requirements

Protection:

- Situation and Person Dependent
- Negotiation
- Leverage

IM Lawyer's Potential Concerns

Potential Conflicts for the Lawyer

- Multiple Party Representation – Cal. R. Pro. Conduct 3-310(C)
- Communication with Represented Party – Cal. R. Pro. Conduct 2-100 (communication with represented party)
- Third Party Payor – Cal. R. Pro. Conduct 3-310(F)

Time Constraints

Employment Agreement Clauses (Cause)

Termination Without Cause

- Risk Shifting
- Definition of Cause
 - Generally Executive Wants a Narrower Definition of Cause
 - Generally Company Wants a Broader Definition of Cause

Executive Story

Pauly, the prospective CEO of a struggling publicly traded high-tech company, negotiated an employment contract for months with the company's chairman of the board, a seasoned industry veteran. Pauly finally had enough and told the chairman that he would not negotiate any further unless everyone showed up in a room to either get the deal done or let it fail.

The following week, the parties and their attorneys met at company headquarters. At some point, the negotiation arrived at the definition of "Cause" in the employment agreement. After reviewing Pauly's proposed definition of Cause, the chairman turned to me, and said, "But if he doesn't perform, I need to be able to replace him."

To which I responded, "The company is taking the risk that Pauly is incompetent. If you think he is incompetent, don't hire him. If he turns out to be incompetent, you'll pay him severance. Incompetence is not Cause."

"OK, I see," the chairman said. The deal got done that day.

Executive Employment Law at p.13.

Employment Agreement Clauses: Cause (cont.)

- **Problem** (Examples of Specific Problem Areas):
 - Trigger for breach of the employment agreement
 - Trigger for actions such as dishonesty without materiality qualifiers and without a “material economic harm” qualifier
- **Protection:**
 - Narrow the definition
 - Eliminate Broad Language
 - Insert a notice provision

Employment Agreement Clauses: Cause (cont.)

Compare Definition of Cause Clauses:

Pro-Executive:

“Cause” shall mean only the Executive’s (i) willful, substantial, and repeated refusal to follow a lawful and reasonable directive of the Company’s Board; (ii) willful, substantial, and repeated gross neglect of his obligations to the Company which causes a material economic loss to the Company; or (iii) conviction of a felony crime involving moral turpitude....

Pro-Employer:

“Cause” shall mean only: (i) Executive’s failure to perform Executive’s assigned responsibilities, (ii) Executive engaging in any act of dishonesty, fraud, or misrepresentation, (iii) Executive’s violation of any federal or state law or regulation applicable to the business of the Company, or (iv) Executive’s breach of any agreement between Executive and the Company....

Employment Agreement Clauses: Good Reason

Good Reason to Resign (Constructive Quit/Good Leaver)

- Definition of Good Reason
- Risk Shifting
- IRC § 409A Limits
- Safe Harbor Notice Clause

Employment Agreement Clauses: Release Clause

Release Requirement For Separation Benefits

Problem:

- The Release
- Other Terms (e.g. one-way non-disparagement clause)

Protection:

- Pre-Negotiate Release
 - Include Carve-outs to General Release
 - Eliminate Language
 - Increase Mutuality of Clauses
- Alternatively, Insert a Good Faith Negotiation Clause with Notice of Carve-outs to Come

Employment Agreement Clauses

Change in Control Clause

Single Trigger v. Double Trigger Protection

- Single Trigger Reference to Termination of Employment & Change in Control
- Single Trigger Reference to Change of Control Only

Non-Competition Agreements/Clauses

Problem:

- The Non-Compete Agreement/Clause Itself
- The Broad Scope of the Non-Compete Clause

Background: California & Federal Law

- California Law - Cal. Bus. & Prof. Code § 16600
- California Court's Enforce Other State Court's Judgments/Injunctions - U.S. Constitution's Full Faith & Credit Clause

Out-of-State Entrepreneurs/Executives Moving to California

- Out-of-State Non-Compete Agreements
- Out-of-State "Inevitable Disclosure Doctrine"

The Past End-Arounds

- The California Supreme Court Defeats The Ninth Circuit's "Narrow Restraint Exception" End-Around
- The California Legislature Defeats The Out-of-State Arbitration & Application of Foreign Law End Around (But will the new law – Cal. Labor Code § 925 withstand judicial scrutiny?)

Non-Competition Agreements/Clauses (cont.)

Protection:

- Eliminate
- Narrow Scope
- Know the Law – Illegal in CA to require a non-compete agreement as a condition of employment
- Cal. Labor Code 925?
 - Will it withstand judicial scrutiny?
 - Exception for employees who are represented by counsel and individually negotiate their employment agreement

Text of Cal. Labor Code § 925

(a) An employer shall not require an employee who primarily resides and works in California, as a condition of employment, to agree to a provision that would do either of the following:

(1) Require the employee to adjudicate outside of California a claim arising in California.

(2) Deprive the employee of the substantive protection of California law with respect to a controversy arising in California.

(b) Any provision of a contract that violates subdivision (a) is voidable by the employee, and if a provision is rendered void at the request of the employee, the matter shall be adjudicated in California and California law shall govern the dispute.

(c) In addition to injunctive relief and any other remedies available, a court may award an employee who is enforcing his or her rights under this section reasonable attorney's fees.

(d) For purposes of this section, adjudication includes litigation and arbitration.

(e) This section shall not apply to a contract with an employee who is in fact individually represented by legal counsel in negotiating the terms of an agreement to designate either the venue or forum in which a controversy arising from the employment contract may be adjudicated or the choice of law to be applied.

(f) This section shall apply to a contract entered into, modified, or extended on or after January 1, 2017.

Executive Story: Alex, Piper & Zoester

"I think I'm about to get fired," began Zoester, CEO of Mazin Switch Corporation (MSC). Five years before, Zoester had founded MSC with long-time friends Piper and Alex. In addition to being friends, Zoester, Piper, and Alex are business symbiotics. Zoester, a vibrant MBA, runs companies, builds sales teams, and raises money. Zoester knew little about MSC's product (except how to sell it).

Piper, a brilliant linguist and thinker, writes code. Piper served as MSC's chief strategist and created MSC's software. Piper's aversion to "all the other things you have to do to make a company work" meant Piper was happy to let the others run MSC.

Alex, a gifted engineer, served as MSC's vice president of engineering and managed MSC's overseas engineering team. Alex's team loved their boss' it's-all-about-the-engineering approach to life.

"We just got an offer for \$200 million for our company," Zoester explained. "We want to take it. It's a 3-X to 8-X return for our preferred investors," Zoester said. "But our investors won't agree to sell because they think MSC will be worth \$1 billion in a few years. They claim we are not putting in the time," the CEO spit out. "We just had another board fight, and I think the VCs are going to fire me. If they don't fire me, I might quit anyway," Zoester said.

"OK, let's start from the beginning," I responded. "Tell me the capital structure . . . Tell me how many board members there are . . . Tell me what the bylaws say . . . Tell me whether you are an officer appointed by the board . . ."

It took about 20 minutes of questions and answers to determine the investors did not have the votes to fire Zoester. The corporate documents guaranteed the founders 50 percent of the board seats, and further provided MSC could not be sold unless all classes of stock, voting separately, agreed to the sale. Zoester, Piper, and Alex controlled MSC's common stock. The investors controlled each series of MSC's preferred stock.

"Because you are appointed by the board, you can only be fired by the board. Even though the investors own 75 percent of MSC, the investors don't have control over the corporation," I explained.

"But the real question," I continued, "is what Piper and Alex are going to do. If one of them votes to fire you, or just abstains, you're gone. Founders often do the best and get the farthest when they stick together, but I cannot tell you how many times I have seen one founder stab another founder in the back, usually when there is lots of money on the line. At the end of the day, the duplicity often winds up hurting all the founders, but when money is involved, people do the nastiest things."

"Piper and Alex are on my side," Zoester assured me. "We own the same number of shares, we are one hundred percent aligned, and we want you to represent all of us," Zoester said.

"So let me get this straight, you three own 25 percent of the company, and you are ready to walk away from \$50 million just because you and the VCs are fighting?" I asked.

"VCs ruined three of my friends' companies. I'll quit before that happens to me and I'll start another company. I've got enough money to do that," Zoester responded.

"Let me be blunt," I said. "How long will it take for the investors to replace you?"

"I'm the MBA. They could probably replace me in a few months, but without Piper and Alex, there is no company. The entire product is in Piper's head or written down in a language no one can understand, and the engineering team is loyal to Alex," Zoester said.

"Do the investors know that if you three walk, the company goes under?" I asked.

"They definitely know the company can't survive without Piper," Zoester replied. "Maybe they think Alex is expendable."

"So you have a negotiation on your hands," I said.

A day later, I spoke with Piper and Alex for the first time. "I don't trust any of the VCs. The New York VC thinks he's king, the VC from Singapore is revoltingly passive-aggressive, but I especially don't trust the one from London. He's bad news," Piper gushed with unrelenting distaste and distrust. "I'm ready to overnight them the keys," Alex chimed in. Hearing Piper's and Alex's comments confirmed for me that the founders were aligned, and I could jointly represent them.

"You three can do what you want," I said, "but I strongly suggest that you not walk away from \$50 million until you see how your negotiation with the investors and acquirer goes. There's a time and a place for everything, but the time hasn't come for you to launch the nuclear weapon and quit. Negotiations have life cycles, and yours has just begun. Why would you give up all your hard work and your potential upside before showing the investors you are serious and seeing how things play out?"

MSC's board held multiple meetings to consider the acquisition offer. MSC's experienced investment banking firm gave a presentation to the board, explaining the proposed deal was in the best interest of all the shareholders. The nay-saying VCs asserted the banker's presentation was biased because the banker would be paid a contingent fee (a success fee) if the deal closed.

"No reason to quit . . . there's lots of life left in these negotiations," I said to Zoester, Piper, and Alex, after they gave me an invective-laden account of the board fight over the banker's presentation.

"How about lunch?" queried the e-mail from investors' counsel a few days later. During lunch, counsel agreed that the principals should meet in a room to attempt to work things out. It made no sense to allow angry parties to destroy a perfectly good company.

The VCs boarded planes, and everyone met face to face a few days later. It appeared that the investors concluded that if they pushed much harder, they risked turning their investment into a zero. Shrewdly, and to the founders' amazement, the VCs did a business mea culpa, stroking the founders' egos and explaining they understood that the founders *were* MSC. The meeting took all day, but the parties were able to focus on business. Eventually, they worked out an agreement that allowed the investors a number of months to set up a win-win plan for their vision for the company. While the investors were working on their plan, the parties agreed MSC should keep the avenues of communication open with the potential acquirer.

Six months later, the investors had not developed their plan, and the acquirer boosted its offer to \$250 million. The board vote to sell was unanimous and genuine.

At the post-deal signing party, everyone showed. One inside cynic watching the VCs shake hands talked about damage control. Another observed that it was just business. "The VCs may have pissed off the founders," he said, "but hey, the fight was worth thirty-seven-and-a-half million more dollars to their investors." A third onlooker remarked that if Zoester, Piper, and Alex's next company goes as well as this one, the VCs would probably want to invest.

Executive Employment Law, pp. 190 – 193.

Q&A

Q&A Now

Q&A Later – jothamstein@jotham.com; 650-327-1900 (Office Number)

About the Presenter

Jotham S. Stein is the principal of the Law Offices of Jotham S. Stein P.C., in Palo Alto, California (www.jotham.com). Mr. Stein has more than two decades of experience representing entrepreneurs and C-Suite executives running myriad types of companies, board members, venture capitalists, private equity principals, investment bankers as well as less senior employees of all size companies. Mr. Stein has negotiated numerous employment agreements, separation agreements, M & A agreements, change in control agreements, stock option agreements, restricted stock agreements, management carve out agreements, non-compete agreements, and much more. Mr. Stein is also a litigator. He has represented individuals and corporate clients in state and federal courts and in multidistrict litigation, before state and federal agencies, and in arbitration, including before JAMS, the American Arbitration Association and FINRA.

Mr. Stein has written a leading book, now in its fourth edition, on how to represent executives and entrepreneurs in their employment relationships. The book is: *Executive Employment Law: Protecting Executives, Entrepreneurs and Employees*. Further information on *Executive Employment Law* can be found at www.evenceosgetfired.com.