

# Employment/Employee Matters

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## Agenda

- Introduction
- Classification of Workers and Significance
- Terms of Employment Relationship/Covenants
- Employee Equity
- IPI Clinic
  - Introduction to Contracts
  - Independent Contractor Agreement
- Questions and Answers

## **Classifications of Workers**

Employees

Independent Contractors

Interns

Trainees

Volunteers

Apprentices

## Employee . . . Or Not?

Why does it matter?

- Many laws apply to employees but not other types of workers
  - W2 or 1099
  - Wage and Hour
  - ERISA/Benefits
  - Employment Discrimination
  - Labor Laws
- Treatment of worker may change

## Misclassification

### Closer Scrutiny

- Misclassification is more common than you might think (NY study: 10% of all private-sector workers misclassified).
- Increased government attention (states have formed task forces on the issue).
- “New” economy means employers may look to cut costs and states will aggressively pursue lost revenues.

## Example – Fair Labor Standards Act

FLSA only applies to employees.

Employee: “any individual employed by an employer.”

29 USC s.203(e)(1).

Employer: “any person acting directly or indirectly in the interest of an employer in relation to an employee . . . .” 29 USC s.203(d).

Employ: “to suffer or permit to work.” 29 USC s.203(g).

The FLSA has “the broadest definition . . . ever included in any one act.” *United States v. Rosenwasser*, 323 U.S. 360 (1945) (quoting from Sen. Hugo Black).

## Employee v. Independent Contractor

### Three Tests of Employee Status

- Right to Control (IRC, NLRA, ERISA, ADA)
- Economic Reality (FLSA, SSA, FMLA)
- Hybrid (Title VII, ADEA)
  - As a practical matter, the lines often blur between the tests, and courts, while purporting to apply either Right to Control or Economic Reality, often end up utilizing a hybrid test.

## A Unified Approach

### Murray v. Principal Financial Group (9<sup>th</sup> Cir. 2010)

- “[T]here is no functional difference between the three formulations.”
- 12 factors identified:
  - Skill required
  - Source of instrumentalities/tools
  - Location of work
  - Duration of relationship
  - Can hiring party assign additional projects
  - Hired party’s discretion over when and how long to work
  - Method of payment
  - Hired party’s role in hiring and paying assistants
  - Work part of regular business of hiring party
  - Hiring party is in business/can work elsewhere
  - Provision of employee benefits
  - Tax treatment of the hired party



## Employment Agencies - Joint Employment

Under joint employment doctrine, employee of Company A can be classified as employee of Company B even though B intends to retain employee as independent contractor

- Example: Worker hired through employment agency

Analysis may change depending on circumstances, but factors are similar to independent contractor tests described earlier

## **Beyond The Employee Question**

Threshold inquiry is whether the worker is an employee.

If a contractor, arrangement is largely contractual (note PHRA coverage; 1099 requirement).

Assuming that worker has the indicia of an employee, the next question is whether the worker must be paid for his/her work.

Certain categories of works, while possessing the indicia of an employee, need not be paid.

## Unpaid Interns/Trainees

Six criteria must be met per DOL (WHD):

- Activities similar to training in an educational setting (but may include operation of employer facilities);
- Experience is for the benefit of the intern;
- Intern/Trainee does not displace regular employees, but works under close supervision of existing staff;
- Employer derives no immediate advantage from work of intern/trainee (and occasionally operations actually may be impeded);
- Intern/Trainee not necessarily entitled to job at conclusion of internship/training; and
- Understanding that position is unpaid.

## Volunteers

### For profit versus non-profit

- Volunteer provisions of FLSA limited to individuals who perform hours of service for public agency for civic, charitable or humanitarian reasons, without promise, expectation or receipt of compensation for services rendered.
- Charitable entities may also utilize the help of volunteers outside FLSA coverage (DOL: volunteer status applies to “those individuals performing charitable activities for not-for-profit organizations.”).
- DOL: “Employees may not donate their services to their for-profit employers.”

## Volunteer Considerations

Relevant factors for distinguishing between volunteers and employees:

- Expectation of compensation;
- Immediate/primary benefit;
- Integral to business;
- Coercion/pressure;
- Time of activity;
- Similarity between volunteer activity and job duties;
- Length of relationship;
- Part-time/Full time.

## For-Profit Volunteers?

“[T]o say that one cannot under any circumstance volunteer for a for-profit entity might be too sweeping a statement.”

- Charitable or civic activity;
- Activities occur outside of normal working hours;
- No obligation to participate or ramifications for choosing not to participate;
- No expectation of compensation;
- Activities performed are different from duties normally performed by employees.

## **Apprentices**

Over 950 occupations recognized as apprenticeable. Apprenticeship program must be registered with either DOL or state apprenticeship agency (half of the states have such agencies).

Program provides some opportunity for unpaid training, but work is paid.

Potential sources of funding exist for apprenticeship programs.

## Employment – In General

- Agreement v. No Agreement (the “Pre-Nuptual”)
- Roles and responsibilities/expectations
- Compensation
  - Base
  - Bonus
  - Expenses
- Benefits
- Equity (TBD)
- Term and termination
  - At-will
  - Severance
  - Accrued Compensation (e.g., commissions)



## Intellectual Property

- Use of Third Party Confidential Information
  - Representation
  - License
- Invention Assignment
  - Significance
  - Current
  - Prospective obligation
- Definition of “Invention”

## Restrictive Covenants

- Confidentiality
- Non-Competition
- Non-Solicitation
- Note: State laws differ

## Restrictive Covenants (cont.)

- Confidentiality
  - Definition of “Confidential Information”
    - In general
    - Typical exceptions
    - Customer confidential information
  - Covenants
    - Maintain confidentiality
    - Restriction on use for other purposes
  - Danger for Company (In general)

## Restrictive Covenants (cont.)

- Non-compete
  - Requirement of consideration (sign before employment)
  - Length of time
  - Substantive scope
  - Geographic scope
  - Reasonableness

## Restrictive Covenants (cont.)

- Non-solicitation
  - Employees (current; former)
  - Customers
    - Current customers (note: What are current customers?)
    - Prospective customers
  - Suppliers
  - Length of Time

## Restrictive Covenants (cont.)

- Remedies
  - Injunctive Relief
  - Extension
  - Buy-back stock (include in equity plan)
  - Collection of legal fees/costs
- Forum for litigation
  - Arbitration v. Courts
- Governing Law

## Employee Equity – Types of equity

- Restricted Stock
- Options
  - Qualified options
  - Non-qualified options
- Profits Interests
- Phantom Equity Plans

## Key Common Terms

- Vesting
  - Time vesting
  - Performance vesting
- Repurchase Right
  - Vested
  - Non-vested
- Obligation to sign shareholder agreement or similar arrangement
  - Restrictions on transfer
  - Drag-Along



## Restricted Stock

- Taxed upon receipt
- Section 83 and Section 83(b) Election
- Potential capital gain treatment
- Current Ownership
  - Participate in dividends
  - Voting
- Most useful early
- Consider funding the tax liability

## Non-Qualified Stock Options

- No tax upon receipt
- Taxed upon exercise at ordinary income rates (fair market value less exercise price)
- Taxed upon sale (capital gain) (sale price less fair market value at time of exercise)
- No ownership of stock until option is exercised
  - No participation in dividends
  - No voting

## Illusive Qualified Stock Options

- No tax upon receipt
- No tax upon exercise (subject to alternative minimum tax on fair market value over exercise price)
- Tax at capital gain upon sale
- No ownership of stock until option is exercised
  - No participation in dividends
  - No voting

## **Restrictions for Qualified Options** (among others)

- Option price must be at fair market value
- Must hold stock for at least one year after exercise
- Shareholder approval of plan
- Employees only
- Non-transferable
- Must be exercised within 90 days after termination of employment

## Profits Interests (LLC's and Partnerships Only)

- Share in value in excess of value upon receipt
- No tax upon issuance
- Treated as a member (share in distributions)
- Voting v. non-voting
- Issue regarding employee v. partner (K-1 v. W-2)
- Potentially confusing to recipients

## Example

### Assumptions:

Company initial value:	\$500,000
Sale at 3 years:	\$5,000,000 valuation
Employee:	1% (1,000 shares out of 100,000 shares)

### Tax Rates:

Ordinary Income:	40%
Capital gain:	15%

## Example

### Restricted Stock

- Tax on receipt:  $40\%$  of  $\$5,000 = \$2,000$
- Tax on sale:  $(\$50,000 - \$5,000) \times 15\% = \$6,750$
- Proceeds to Employee:

\$50,000
(2,000) initial tax
<u>(6,750) tax on sale</u>
\$41,250

## Example

### Non-qualified Options

- No tax on receipt
- Exercise Price: \$5,000
- Tax on exercise:  $(\$50,000 - \$5,000) (.4) = \$18,000$
- Proceeds to Employee:

\$ 50,000  
    (5,000) exercise price  
    (18,000) tax  
\$ 27,000



## Example

### Profits Interest:

- No tax on receipt
- Proceeds: 1% of increase in value over \$500,000  
=  $(\$5M - \$500,000) \times .01 = \$45,000$
- Tax on sale  $(\$45,000 \times .15) = \$6,750$
- Proceeds to Employee:

$\$45,000$   
 $(6,750)$  tax on sale  
 $\$38,250$

## Example

### Comparison of After - Tax Proceeds

Restricted Stock:	\$41,250
Non-Qualified Option:	\$27,000
Profits Interest:	\$38,250

## Bottom Line on Equity

- Restricted stock is best if company has low value
- Profits interests are attractive if entity is a limited liability company
- Non-qualified options are an attractive vehicle
- Don't forget about 83(b) elections

## Considerations in the Amount of Equity

- The purpose is to attract and maintain talent
- Think about the future
- Many employees do not value equity
- An option pool can be replenished
- 10-15% employee option pool is “standard”
- A large pool may work against the Company in a financing

## Independent Contractor Agreement - Contracts

- Contract
- Read and Understand
- Confirm business points
- The “drafter” controls
- Ask “what if’s”
- Consider
  - Breaches
  - Remedies
  - “Who decides, who decides”
  - What happens while issues are being decided

## Independent Contractor Agreement – IPI Session

- Objective
- Next steps

## Questions and Answers