

Agenda

- Introduction
- Classification of Workers and Significance
- Terms of Employment Relationship/Covenants
- Employee Equity
- Questions and Answers (but don't wait)

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 (9th 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 workers, 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.
- Apprentice 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 Agreements for Start-ups

- Start-ups should always have written agreements with employees
 - Oral agreements are enforceable
 - Avoid misunderstanding (potential litigation)
 - Enforceable covenants



Review carefully!!!!



Key Terms

- Roles and responsibilities/expectations
- Compensation
 - Base
 - Bonus
 - Expenses
- Benefits
- Term and termination
 - At-will
 - Severance (don't overdo this)
 - Accrued Compensation (e.g., commissions)

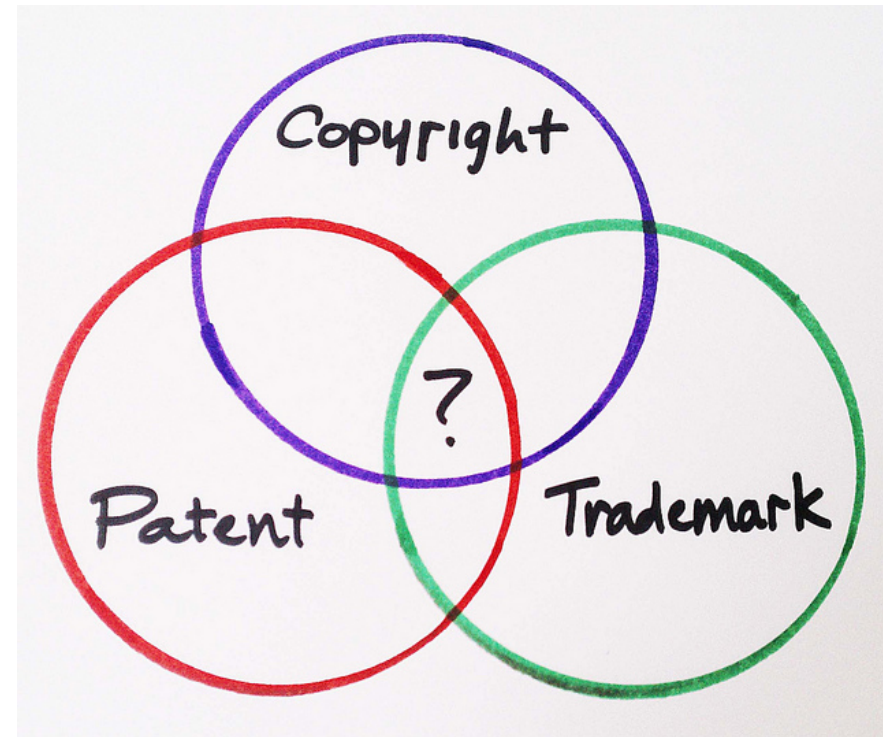
Important Provisions for Start-Ups

- Invention Assignment
- Confidentiality
- Non-Competition
- Non-Solicitation



Intellectual Property

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





Confidentiality Provisions

- 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)

Non-Competition

- Consideration (sign before employment)
- Length of time
- Substantive scope
- Geographic scope
- Reasonableness



Non-Solicitation

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

Enforcement

- Remedies
 - Injunctive Relief
 - Extension
 - Buy-back stock (see 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



Important Terms

- Vesting
 - Time vesting
 - Performance vesting
- Repurchase Right
 - Vested
 - Non-vested



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)

- C Corporations only
- 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: $40\% \text{ of } \$5,000 = \$2,000$
- 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
<u>(18,000) tax</u>
\$ 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
<u>(6,750)</u> tax on sale
\$38,250

Example

Comparison of After - Tax Proceeds

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

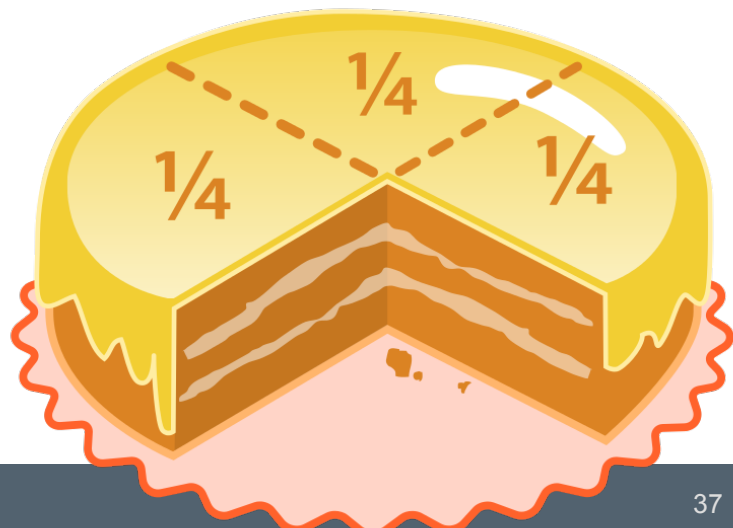
Bottom Line on Equity

- Restricted stock is best if company has low value
- Profits interests are attractive if entity is a limited liability company (but, again, are confusing)
- 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 – IPI Session

- Objective
- Next steps