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Five Common Employment Law Hazards for Start-Ups

Article By
Michael L. Rosen
Foley Hoag LLP

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Emerging, venture capital-backed companies typically face a host of legal considerations but have limited personnel and monetary resources to address all of them comprehensively. Often lacking in-house human resources and legal expertise, many emerging companies employ a "band-aid" approach to HR-related issues, addressing problems only as they arise. There are, however, a few common employment law issues to be aware of, and a bit of advance understanding and planning can do a great deal to minimize the downstream risks of expensive legal headaches.

Distilled here are five employment law hazard areas that managers at early-stage companies often encounter. These areas, Ihave found, are where employment-related disputes most consistently arise at venture-backed start-ups.

Exposure to Liability in the Hiring Process

The movement of talent between companies — particularly but not exclusively competitors — is fertile ground for legal problems, including litigation. Again and again, we see emerging companies unwittingly getting into legal trouble in the hiring process, both because of the existence of restrictive agreements between new hires and their previous employers and because of problematic conduct engaged in by these individuals as they leave their previous employers. Small, VC-backed companies often are in a permanent recruiting mode, and they are anxious to bring in talent. Alack of careful management of the hiring process can result in vexing legal problems.

Acommon scenario is a new hire who is subject to a restrictive covenant that the hiring employer does not know about. This could be a non-competition agreement, or it could be some other sort of a restrictive covenant, such as an employee or customer non-solicitation agreement. In the latter example, if the new hire has already solicited his old customers or coworkers, the hiring company may be exposed to legal claims even without knowing the hire was subject to this restriction.

Start-up companies need to be proactive and organized in identifying precisely what continuing restrictions apply to their new hires and should involve legal counsel to give them guidance as to what impact the hiring may have. The hiring company should not simply take the candidate’s word that he or she is not subject to a restrictive covenant. Indeed, simply asking a candidate whether he or she signed a non-compete may not be sufficient to obtain relevant information. The situation is not so straightforward because terminology in this area is not precise, and employees often do not understand what they have signed in the past. Hiring companies should ask detailed, direct questions to discover what existing restrictions may be in place. Specifically, hiring companies should inquire about pre-existing nondisclosure agreements, agreements concerning developments and assignment of inventions, non-competition agreements, and non-solicitation agreements. Companies also should ask whether any of these sorts of restrictive covenants are included in a candidate’s equity-related agreements (option or restricted stock agreements), or in bonus plans and/or commission arrangements. If there is any question about the existence of post-employment restrictions in such documents, hiring companies need to obtain and review the documents, rather than accepting a candidate’s assurances that, for example, he or she only signed a nondisclosure agreement.

Once in hand, restrictive covenants should be reviewed to determine whether the company can hire the employee despite the existence of post-employment restrictions. Typically, this will involve an assessment of the legal risks, if any, posed by the potential hire. Careful consideration of the applicable state law as applied to the particular candidate’s circumstances is key.

Once a decision is made to hire a candidate subject to post-employment restrictions, the company should document precisely its understanding and expectations in an offer letter or employment contract. In particular, the company should state its understanding that the individual is subject to a specific agreement and is required to abide by it. If the individual has represented that he or she is not subject to a restrictive agreement, that fact also should be stated in the hiring documents. This may help insulate the company from liability in the event that the employee’s representation was false.

Whether or not the candidate is subject to post-employment restrictions, hiring companies need to be especially vigilant about ensuring that they do not unwittingly find themselves named as defendants in lawsuits alleging misappropriation of trade secrets and confidential information. The last decade has seen a notable increase in claims in this area, largely stemming from the evolution of technology in the workplace and, in particular, companies' abilities to track the computer-related activities of departing employees.

Many companies now look at employees' computer activities when they receive notice of a departure, in some instances using sophisticated forensic tools to uncover activities that employees may have believed could not be detected. Because of these practices, hiring companies should take a careful and strategic approach to the hiring process, particularly where employees are moving within the same industry.

This means managing the hiring process from the outset. Candidates should be given clear instructions about what they can and cannot do prior to starting with the new company. Ideally, they should be advised in writing not to take, delete or destroy any documents, including electronic information, and to return all of their prior company's property immediately upon termination. In addition, candidates should be given clear instructions about what contact, if any, they are permitted to have with customers and coworkers about the departure before they leave. Also, communications about the hiring should never be made on the prior employer's time or equipment, even if using a personal e-mail account. Such conduct can only raise suspicions about improper conduct. Ultimately, a hiring company may be exposed to several possible claims, even absent a non-compete agreement, such as misappropriation of trade secrets, breach of fiduciary duty, tortious interference with advantageous relationships and violation of federal and state computer fraud statutes.

Failure to Adequately Document Terms and Conditions of Employment

A related problem in the hiring process is the failure to adequately document basic terms and conditions of employment. Many start-ups begin with verbal agreements and handshakes. Ideally, early on, all arrangements should be formalized with basic documentation. That documentation — whether it takes the form of an offer letter, employment contract and/or other documentation — should accomplish some specific things. First, assuming the company's intention is to retain employees on an at-will basis, an offer letter or initial employment agreement should clearly document that fact. The following language typically will suffice: "You will be employed on an at-will basis, meaning that either party may terminate the employment relationship at any time for any reason, with or without notice." Second, the hiring document — generally an offer letter — should spell out any contingencies, such as the fact that the hiring is contingent on specific funding becoming available, or the fact that the hiring is contingent on the employee's execution of a non-disclosure/non-competition agreement. Third, the individual's rights to stock or stock options should be spelled out clearly. The failure to adequately spell out equity rights — including vesting terms, exercise price, rights at termination, and change-of-control contingencies — is a particularly common source of disputes within start-ups. Many early-stage companies are sued as a result of some conversation that never gets properly documented, or a set of e-mails that never really become a concrete agreement.

Similarly, at many emerging companies, commission and bonus arrangements are a work in progress, as goal setting and expectations about future revenues are constantly in flux. This is an understandable phenomenon, but it also fuels disputes about what is owed to an employee when he or she leaves. One common example of this problem is the situation where the employee leaves after making a sale or profit, but before the revenues are realized. Another variation involves an employee who is terminated close to year end, before bonuses are paid out.

The problem of commission arrangements following employment is a recurring one with many companies. It makes good sense early on to do a little bit of thinking and to document how commissions and bonuses are to be calculated given various contingencies. Such commission and bonus plans need not be complicated, overly legalistic documents. A one-page or two-page plan, signed by the employee, documenting the appropriate formula, and spelling out what will happen in the event of termination, can help avert disputes about compensation at termination.

Misclassification Issues

In many emerging companies, management is not attentive enough to appropriate classifications of new hires. The most significant areas of risk are (a) the misclassification of workers as independent contractors (rather than employees), and (b) the misclassification of employees as exempt from federal and state minimum wage and overtime laws.

Employee or Independent Contractor?

Early-stage companies historically have been prone to engage the services of independent contractors rather than employees for a number of reasons tied to the perceived flexibility such an arrangement provides. Some companies prefer to provisionally retain workers as independent contractors as a kind of “probationary period,” and then to convert them to employees if the parties desire to continue working together. Other companies utilize the status as a kind of hedge against uncertainty: if the company later cannot afford to pay the contractor or does not have enough work to keep her busy, it is a relatively simple proposition to cut ties by terminating the contract.

Fundamentally, a proper independent contractor classification avoids the panoply of federal and state laws governing the employment relationship. One reason companies engage contractors is to avoid these significant legal requirements, including tax withholdings and wage and hour requirements (such as timely payment of wage laws, minimum wage and overtime requirements) and various discrimination laws. In addition, independent contractors typically are not covered by health insurance and other employee benefit plans, lowering the costs of these benefits for companies.

But emerging companies should be extremely careful about classifying their workers as independent contractors. Several years ago employment lawyers referred to this as the “Microsoft” problem, referring to a high-stakes case brought against Microsoft in the 1990s alleging that thousands of workers were misclassified, ultimately resulting in a $97 million settlement. Currently, this might be called the “FedEx” problem, in light of the well-publicized class action cases filed nationwide against FedEx Ground relating to its alleged misclassification of drivers as independent contractors. In that case, significant overtime and other compensation may be due the drivers if they are successful in their claims.

Although the stakes are not going to be as high with a 50-employee company, the risks are still significant under the multiple federal and state laws that hinge on whether a person is considered an employee or an independent contractor. The Internal Revenue Service has issued what is commonly referred to as the “20-factor test” to assist employers in understanding whether they can classify an individual service provider as an independent contractor. Also known as the “control” test, it focuses on the degree to which the company retains the right to direct and control the worker with respect to when, where and how the work is performed. This was developed to address the most basic issue: whether the company would have to withhold payroll taxes. If the company gets that wrong, it can be found liable for back taxes and penalties.

A number of other federal laws also hinge on this classification, including the Fair Labor Standards Act (concerning minimum wage and overtime compensation), the employment discrimination laws (Title VII, Americans With Disabilities Act, Age Discrimination in Employment Act), the Family and Medical Leave Act, and the Employee Retirement Income Security Act (ERISA), all of which do not cover individuals who are independent contractors. In addition, many states — including, for example, California and Massachusetts — have laws that are more stringent than the IRS test. These laws can affect whether individuals ought to be covered under workers’ compensation policies, whether terminated service providers can file for unemployment benefits, and whether individuals are owed wages under state wage and hour laws.

Simply put, in many early-stage companies, workers who are classified as independent contractors are actually misclassified.It is important to be focused on the issue early, and it is advisable to err on the side of caution. Employers are better off in many instances hiring the person, spelling out the terms and the conditions of his or employment (including provisional, part-time and temporary employment arrangements), and avoiding the misclassification problem altogether.

Exempt or Non-exempt?

Akin to the independent contractor/employee problem is the question whether companies are complying with federal law regarding overtime pay. In particular, many emerging tech companies make the mistake of assuming that because their workforces are "white-collar" and all of their employees are paid a salary, they need not worry about overtime issues for any employees. In fact, not all salaried employees working in an office are exempt from the overtime pay requirements of federal law.

The federal Fair Labor Standards Act (FLSA) mandates that companies pay one and one-half times the regular rate of pay to employees for hours worked in excess of 40 during a work week, except for those employees who are "exempt." Many early-stage companies lose sight of the FLSA based on the prevalent misconception that the FLSA applies to factory workers or "blue-collar" workers who fill out a timesheet or punch a clock, not white-collar workers in a highly skilled, high-salary job.

To be exempt from federal overtime (and minimum wage) law, an employee must satisfy both a salary requirement and a duties test. The salary requirement is two-fold: that the employee be paid on a "salary basis," and that the salary be a minimum of $455 per week (except that exempt computer employees may be paid at least $455 per week on a salary basis or on an hourly basis at a rate not less than $27.63 an hour).

Being paid on a "salary basis" means an employee regularly receives a predetermined amount of compensation each pay period on a weekly, or less frequent, basis. The predetermined amount cannot be reduced because of variations in the quality or quantity of the employee’s work. Subject to certain exceptions, an exempt employee must receive the full salary for any week in which the employee performs any work, regardless of the number of days or hours worked. If the employer makes impermissible deductions from an employee’s predetermined salary — for example, docking an employee’s pay because of a partial-day absence — the overtime exemption can be lost. If the employee is ready, willing and able to work, deductions may not be made for time when work is not available.

Moving past the "salary basis" requirement, it is the "duties" requirement that is most problematic for employers. The overtime exemption exists only for employees who properly can be classified as "professional," "executive" or "administrative," and for certain "outside sales" and "computer employees." To qualify for one of these exemptions, employees generally must meet certain tests regarding their job duties. Job titles (and even written job descriptions) do not determine exempt status. In order for an exemption to apply, an employee’s specific job duties and salary must meet all the requirements of the U.S. Department of Labor’s regulations.

Simply put, many positions within small companies do not meet the duties threshold to be considered exempt from overtime requirements. For example, many clerical, administrative and technical employees do not satisfy the relevant tests. Companies that misclassify employees as exempt can be liable for unpaid overtime compensation (additional half-time compensation for hours in excess of 40 during any particular work week) over a two- or three-year period. Those damages can be doubled if the violation was willful and a prevailing party is entitled to attorneys’ fees.

Rectifying a misclassification situation can be difficult, because management must inform such workers that going forward, they are going to be treated as non-exempt and eligible for overtime. Putting aside the morale issues inherent in these situations, companies must decide whether and how to compensate these employees for previous "overtime" worked.

A start-up should think about this issue not only as it hires employees, but as it expands its workforce and creates new roles. Early on, many start-ups have one or more employees who wear different hats, engaging in multiple tasks (and performing multiple jobs) on a daily basis. As the company grows and roles are more clearly differentiated, companies need to continue to reassess the particular jobs within the company and determine whether individuals in those roles are being properly classified for overtime purposes.

Ideally, start-ups should consider the exemption issue both at hire (for particular jobs) and on a yearly basis (for the workforce as a whole). This is an area in which some proactive planning and legal analysis can avoid significant downstream legal trouble.

Failure to Comply with Wage Payment Laws

Emerging companies should be sensitive about the issue of timely payment of wages and the problem of wage deferrals. In particular, companies should be aware of the varying state laws concerning the frequency and manner of payment of wages to employees. This area generally is not governed by federal law, and state laws differ widely.

In Massachusetts, for example, hourly workers cannot be paid on a monthly or even semi monthly (twice per month) basis, but rather must be paid no less frequently than bi weekly. While this may seem like a technicality, getting it wrong is actionable. What is important to understand is that there is little flexibility in the area of statutory wage liability. Employees generally cannot agree in advance to waive their rights in this area, as wage deferral agreements generally are not enforceable in many states.

This issue is particularly a concern for emerging companies, as cash-poor companies waiting for the next round of financing or for a sales-based revenue injection may want to ask their employees to agree to defer their wages temporarily. Such agreements are unenforceable under many states' laws, and liability in this area can be significant. Many states' laws impose multiple damages and attorneys' fees for failure to pay wages on a timely basis. In addition, in some states, individual managers, officers, and even directors can be personally liable for failing to pay wages.

Inadequate Protection of Intellectual Property

It has been said that a company's intellectual property walks out the door every day when its employees leave the building. The information that is entrusted to a company's employees is its lifeblood. All too often, however, start-up companies do not do enough to protect their own intellectual property and customer goodwill after their employees leave the company. Unfortunately, some companies take a superficial approach to this crucial issue.

Many emerging companies use a standardized offer letter and intellectual property agreement, focused on non-disclosure of information, assignment of inventions, and, in some instances, non-competition and non-solicitation restrictions. As a starting point, this may suffice, but planning and vigilance are necessary to ensure that companies are in an optimal position to enforce such agreements down the road.

A starting point is to recognize that one size does not necessarily fit all, particularly when it comes to non-competition and non-solicitation agreements. Companies should give careful thought to tailoring restrictive agreements to particular employees or job classes, rather than using a boilerplate agreement provided to many categories of employees, as a more focused, narrowly tailored agreement is more likely to be enforced in court. Similarly, companies should consider defining what they consider to be "competitive" activity rather than simply barring employees from joining any employer that "competes" with the company. Companies should also give careful thought to defining what they consider to be confidential, proprietary information, beyond the typical (and important) boilerplate about "inventions and developments, customer lists, business plans, etc." Ultimately, when attempting to enforce a restrictive agreement in court, the company will be arguing that its confidential information is at risk based on the former employee’s actions; agreements should be drafted to maximize the likelihood that this argument will be accepted.

State law can vary significantly with respect to these matters. As such, a New York company cannot simply give a newly hired California salesperson its standard New York agreement and tell him or her that he or she is going to be subject to New York law. In California, non-competes are almost always unenforceable and California courts generally will not recognize a provision choosing another state’s law. As a result, companies must consider formulating agreements tailored to the specific laws of the states in which they have employees.

In addition, companies need to be careful about the process by which these agreements are signed. Here is a hypothetical example of a major pitfall encountered by start-ups in this area: Widgetronics, Inc. has a new hire sign an offer letter stating that the offer is conditional on the person signing the company’s standard non-competition agreement. However, the company fails to require the individual to sign the non-compete until a week after he or she starts work. In some states, this lapse may defeat the company’s argument that the agreement is supported by adequate legal consideration, and it therefore may undermine the enforceability of the non-compete.

Looking past the hiring and initial documentation process, companies should develop a comprehensive program to protect trade secrets and other confidential information. Ultimately, doing so will significantly improve a company’s prospects when seeking enforcement of restrictive covenants and/or claiming theft of such information. This should include the development and regular dissemination of a confidentiality policy, education and training of employees on intellectual property issues, restricting access (via passwords, locks, etc.) to sensitive information to those employees who need such access, and labeling confidential documents (both hard copy and electronic).

In addition, companies should develop an exit process that lays the groundwork for the possibility of later enforcement of existing agreements and policies. A significant component of this process should be the consistent use of a termination checklist or exit document that reminds workers of their obligations under existing confidentiality policies and agreements. The exit process should ensure that the company takes steps to obtain immediately whatever company property and information the person has possessed, including laptops, PDAs, storage media (discs, drives) and hard copies of documents. If the company has any suspicions about the outgoing employee’s conduct and/or intentions, immediate consideration should be given to actually investigating the employee’s computer-related activities prior to his or her departure. In many instances, retention of a third-party data recovery expert may be advisable both because of the technical challenges involved in investigating electronic activity and because of the need to preserve evidence of that activity. Finally, in some instances an appropriate IP-protection process will involve communicating to the former employee and his or her new employer about the existence and continued applicability of the employee’s restrictive covenants and the company’s expectations about compliance with those promises.

Taking all of these steps will significantly improve a company’s chances of protecting its intellectual property following a valued employee’s departure.