Seton Hall Law Review

Vol. 11 1980 No. 2

EMPLOYMENT ARRANGEMENTS IN CLOSE CORPORATIONS

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I. THE DIFFERENT TYPES OF EMPLOYMENT CONTRACTS

The close corporation may have three types of employment arrangements: (1) those with ordinary employees, *e.g.*, the clerk in the store, the delivery boy, the stenographer, the assembly line employee, etc.; (2) those with significant employees (key employees) whose services will be important enough to the success of the business to require contracts of employment, *e.g.*, a commission salesman; and (3) those with the participants themselves (*i.e.*, the owners) where the employment contracts will be designed as a vehicle for insuring continued and adequate financial participation in the venture despite a possible minority control position.

Subject to the provisions of Title 34 of the New Jersey Statutes Annotated, anti-discrimination laws, and any union contract, employees in the first category will be hired, paid, and fired at the will of the Board, or frequently the officers, or even other ordinary wage-earning employees who have been delegated the authority to make these decisions. There will be no written contracts with the individual employees.[1]

For employees who will be paid a salary plus a commission, or who will be entrusted with trade or business secrets, written con-

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This article will form the basis for a new chapter in the author's book, New Jersey Close Corporations, published by Callaghan & Co., Wilmette, Illinois, which is currently being revised.

[1] It may be wise to have even ordinary employees sign a written document, at least in the form of an employment application, in order to avoid possible claims that the employment was for a specified term rather than at will. *See* L. MANDEL, THE PREPARATION OF COMMERCIAL AGREEMENTS 165-66 (7th ed. 1978). Mr. Mandel also suggests that the statement that the hiring is at will be in bold face type right above the employee's signature, and that it be read to him by the person in charge of personnel. He further suggests a provision in the application expressly stating that the employment arrangement cannot be changed orally. *Id.*

Wherever trade secrets, customer lists, or other sensitive information will be disclosed to the employee, a formal contract protecting secrecy is, of course, essential, no matter what the level of the employee. The covenant not to disclose should also be bolstered by a non-competition covenant.

tracts may be necessary for the protection of both the corporation and the employee, by not only setting the method of computation of the employee's compensation, but also fixing the relative rights and duties of the parties. These people fall in the second category.

For the owners of the business, the third group, employment contracts may provide, in addition, protection against ouster from management participation, and, accordingly, some assurance of continued financial participation possibly even beyond that provided for in the employment contract.

In an ordinary tax corporation, a participant-employment contract may be essential to assure that a minority participant receives some financial return from the business. Otherwise, the majority, unless they consent to insertion of a mandatory dividend provision in the certificate of incorporation, may completely withhold all dividends, preferring to accumulate corporate profits in order to withdraw them later on at capital gains rates, or perhaps, to deliberately "freezeout" the minority participant in order to force him out of the business.

In a Subchapter S corporation,[2] a mandatory dividend provision will probably be utilized since the participants will be taxed on the corporate profits, and will, therefore, not want to pay a tax on profits they may never receive. Accordingly, in such an electing corporation the participant-employment agreement, although still useful (especially where I.R.C. section 1348[3] will be relevant), will perform the function of increasing financial participation for the brains or service contributor over what his cash contribution would otherwise bring. Thus, in a two-man operation, a service contributor may only be able to afford to put up $1,000 while the "money man" may put up $9,000. If stock of, *e.g.*, $1 par, is issued at par to each, in exchange for his cash contribution, the money man will be taxed on 90% of the corporation's profits, and will probably insist on receiving them. The service contributor will undoubtedly want the value of his services skimmed off the top before such profits are paid out. The employment contract can be used as a means of providing for this more equitable distribution.

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[2] *See generally* I.R.C. §§ 1371-79.

[3] I.R.C. section 1348 limits a taxpayer recipient's tax on "personal service income," which includes a reasonable salary, to 50%, rather than the 70% maximum tax which may otherwise apply. *Id.;* I.R.C. § 1. Needless to say, the significance of I.R.C. section 1348 will depend on the tax brackets of the participants. If all are in a high tax bracket Subchapter S will probably not be chosen unless initial losses are expected. On the other hand, if a number of participants are in lower brackets, or service contributions (and accordingly, compensation for them) on the part of some participants will be disparate, Subchapter S may still be viable even in a business expected to be profitable.

In either type of corporation, if the participant-employee is also a director, and board unanimity is required by the certificate of incorporation (or a bylaw he can protect from amendment) for all director action, or at least for firing him, he will be guaranteed (absent breach of the agreement by him) at least the compensation provided for in the contract for its full term.[4] By virtue of his board position, he will also be able to exert whatever power a single director is given under the certificate of incorporation, which, if a unanimity requirement for all or even only significant director decisions is provided for, will be considerable. If his veto includes a power over compensation or profit distribution to the other participants, his bargaining position may result not only in protection of his financial stake in the business, but increased participation, where the business proves profitable, through his ability to condition increases for the others on something more for himself.

In either type of corporation, if he has been given officer status, the existence of the employment contract preventing complete ouster, except on pain of damages, may also provide a sufficient disincentive even to attempts by the remaining participants to oust him as an officer. His officer status could also be independently protected either through a board veto power, or, if the bylaws provide for election of officers by the shareholders,[5] through a shareholder veto power.[6]

The formal parts of the employment agreement for persons in both categories two and three will bear at least a superficial resemblance. The extent of difference will depend on the relative bargaining positions of the important employee, as opposed to that of the minority financial participant, and as a result, in many cases, the two agreements will be indistinguishable. In general, however, the "important employee" contract will still favor the corporation, while the participant-employee contract will be biased in favor of the participant employee.

It is to be noted that to give the fullest protection to a participant, intermeshing employment contract, certificate of incorporation, and shareholder agreement provisions are all necessary. Thus, there

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[4] Under N.J. STAT. ANN. § 14A:6-7(1) (West 1969), a high vote requirement for director action can be imposed. The participant's compensation claim may possibly be entitled to priority in the event of corporate insolvency. *See* N.J. STAT. ANN. § 14A:14-21(3) (West 1969).

[5] The provision for shareholder election of officers can be contained in the by-laws. N.J. STAT. ANN. § 14A:6-15(1) (West 1969). The by-law can be made unamendable, except by the shareholders. N.J. STAT. ANN. § 14A:2-9(1) (West 1969). Officers elected by the shareholders can only be removed by them. N.J. STAT. ANN. § 14A:6-16(1) (West 1969).

[6] See N.J. STAT. ANN. § 14A:5-12(1) (West 1969) as to shareholder veto.

will be no veto without the appropriate certificate or bylaw provisions which may not happen to be inserted without a prior shareholder agreement. There will be no director power unless the participant is elected as one—a result which can be guaranteed only by a shareholder agreement where the participant lacks sufficient shares himself to insure his election.

Since to perform its power-financial function to the maximum extent the employment contract for the participant will still require a shareholder agreement, it is simpler to incorporate participant employment arrangements in the underlying shareholder agreement, which can, through its terms and agreement as to what the certificate and bylaws will contain, provide the complete framework for operation of the corporation.

The number of additional protective devices given to the participant-owner's employment arrangement will depend on his bargaining position with his co-participants; perhaps, even though it is contemplated that he will be given additional share participation if he proves himself, full participant power may initially be denied to him. In such a situation, a separate employment contract may be indicated.

Since statuses within the corporation may change, a younger person, even though regarded as a potential owner, may initially be relegated to second category status. Here again a separate employment contract, perhaps coupled with an option to purchase shares, will be used.

Some authorities even suggest a separate agreement for the initial owners on the ground that changes in the employment contracts may occur more frequently than is desirable for the overall shareholder agreement, and, therefore, a separate agreement provides greater flexibility.[7] This objective can be achieved, however, by having a differing term for the employment arrangement from that of the basic agreement, in the shareholder agreement itself.[8]

Whichever alternative is used—separate agreements or a different term for the employment provisions in the one shareholder agreement—a problem may be presented for the participant-employee unless all participant-employee contracts expire at the same time, and he has sufficient bargaining power (*e.g.*, through a veto on

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[7] C. ISRAELS, CORPORATE PRACTICE § 4.17 (3d ed. 1974).

[8] A single shareholder agreement with only one term for both the underlying obligation and the employment arrangement may be equally satisfactory, however, where there is an adequate provision for compensation increases included.

the board over the other participants' arrangements) to insure a new contract or renewal which will be fair to himself.

Where the employment arrangement is to be used as a protective device for a participant, and its terms are to be included in the shareholder agreement, obviously those terms must be agreed upon when that document is drafted. Even where a separate agreement is chosen, it is obvious that it must be drafted at the same time as the underlying shareholder agreement, the certificate, and bylaws, if the additional protective devices discussed above are to be utilized. Even if the bargaining position of the participant does not justify such protection as insurance of a board position, and board or shareholder veto, advance drafting will still be necessary, since it will be essential to guarantee that the agreement is actually signed and the corporation becomes the actual employer.[9] Needless to say, a minority participant should be unwilling to invest in the business without the assurance that this will be done, where he is placing reliance or partial reliance on the employment contract as a means of insuring a return from that investment. To insure such adoption of the employment arrangement by the corporation the shareholder agreement should agree to it, and bind the parties to cause the corporation to enter into it. This will require attaching the employment contract as an exhibit to the shareholder agreement or at least setting forth therein the general terms of the agreement which will be entered into, together with a promise to cause the corporation to enter into the contract. The attachment procedure, or full incorporation of the employment arrangements in the basic shareholder agreement, is obviously the simpler procedure.

II. Terms of the Employment Arrangement

As indicated above, a separate agreement will be used for a nonparticipant significant employee. For a participant-employee a separate agreement can be used, or the terms of the arrangement can be set forth as a part of a comprehensive shareholder agreement among the parties governing all aspects of the corporation set-up.

For both participants (whether or not in a separate agreement) and nonparticipants, the employment agreement will probably con-

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[9] The participant to be given the employment contract might make his share subscription contingent on grant of the contract by the corporation after its formation, as an additional guarantee of corporate adoption. *See* Brautigam v. Dean & Co., 85 N.J.L. 549, 89 A. 760 (Sup. Ct.), *aff'd*, 86 N.J.L. 676, 92 A. 344 (E. & A. 1914).

There is some authority, however, for the binding effect of a promoter's preincorporation employment contract. *See* Annot., 66 A.L.R.3d 1138 (1975).

tain, in addition to the formal parts (parties, including the corporation; recitals; and signatures, again including the corporation), provisions dealing with the following:

1. Term of employment;[10]
2. Employee duties, including time to be devoted[11] (including out-

[10] A fixed term can of course, be used. In a participant agreement a term of employment for so long as the employee owns shares in the corporation might be used instead. Even if it is not, the employment contract should provide for its termination once the officer or employee no longer owns shares, and conversely, for his protection, some arrangement for repurchase of his shares if his employment and/or officer status ceases.

Needless to say, if the employment arrangement uses the period of share ownership as its term, a provision for adjustment of compensation, or at least allowing extrication from share ownership as a means of terminating an employment arrangement no longer profitable to him, is exigent to prevent unfairness to the employee-participant.

[11] Where the employment is not full-time, special provisions are necessary. Thus, the agreement might provide:

> The parties acknowledge that ________ is presently engaged in the business of ______, and they expressly consent to the continuation of such activities by him, whether directly or through any partnership or corporation.

A waiver of the right to assert any claim that the party allowed to engage in outside activities has "pre-empted a corporate opportunity" might also be added, to prevent any obligation on his part to turn over to the corporation any investment opportunity that might come to him through that outside activity. For example, if he is engaged in the buying, selling, and development of real property, and will be allowed to continue this activity, the following might be added:

> The parties expressly waive any right, personal or derivative, to assert that any acquisition, whether directly or through any corporation or partnership, of any interest in real property by ______ constitutes a breach of his fiduciary duty to the corporation or any of the shareholders of this corporation.

Needless to say, great care must be taken to prescribe the duties, including the amount of time to be devoted to the business, where any of the parties is not to be full-time. Care must also be taken to prescribe the extent of outside activities, including new business opportunities, that will be allowed. Otherwise, misunderstandings are bound to arise.

Where a permitted activity for a particular participant is carved out, it may also be desirable to prohibit the other participants from competing with him in that activity. The following might, therefore, also be added:

> The parties further agree that, so long as ______ is a shareholder, none of the other parties will as shareholder, director, officer, partner, principal, agent, employee, or otherwise, engage in the business of ______.

Where, as in the example, the permitted outside activity may overlap a necessary activity of the business being formed, an exception to the noncompetition clause might be added. *E.g.*, "provided that the foregoing shall not prevent the corporation formed hereunder from [purchasing, holding, or selling real property] incidental to its business." Obviously this is an area where individualized tailoring is essential. *See, e.g.*, 6 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, Form 15.03, §§ 7,8 (1980) (form where display advertising is to be permitted outside activity).

side activities to be permitted), and possibly who can prescribe; place for performance;[12]
3. Employee powers, and possibly who can fix,[13] and employee liability for exercise of powers beyond those permitted;
4. Compensation,[14] including fringe benefits, pension and stock purchase rights if any, and continuation of wages to surviving spouse, or on disability, if agreed upon;
5. Reimbursement of expenses, and other "perks" (perquisites) including, of course, vacations;
6. Restrictive covenants against competition during and after employment, including nondisclosure of trade and business secrets;
7. Termination of employment, conditions for, who has power to terminate, and rights on wrongful termination;[15]
8. Provisions for renewal or extension, if any have been agreed upon;
9. Provisions for resolution of disputes, if any have been agreed upon (*e.g.*, arbitration);
10. Provisions for enforcement, including possibly specific performance, liquidated damages, especially concerning noncompetition provisions;
11. "Boilerplate provisions," *e.g.*, agreement binding on parties,[16] legal representatives and corporate successors in interest; provisions as to delivery of notices; a provision stipulating that the agreement contains the entire agreement of parties, and is not orally modifiable; waiver of one breach not to constitute waiver of other conditions or subsequent breaches; law applicable; severability.[17]

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[12] This will prevent moving the employee to an unbearable location in order to get him to quit. Of course, especially for a nonparticipant employee in a selling capacity, it will probably be desirable to allow the corporation to change the place for performance, at least within certain limits. A provision might then be included for the cost of relocation, or living expenses while away from the principal base of operations.

[13] For a participant, officer status can be provided for here.

[14] Of course, the terms of payment must be included with the compensation provision.

[15] Sale of the business might be allowed to trigger termination, especially where the employee is a participant. For an appropriate form see 5 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, Form 12.01 § 12 (1980).

[16] Richards, *Drafting and Enforcing Restrictive Covenants Not to Compete*, 55 MARQ. L. REV. 241, 250 (1972) suggests having the employee's wife also sign a covenant not to compete, to prevent the employee from distinguishing his violation of the covenant by having his wife form a corporation for which he then goes to work in competition with his former employer. Since it is not clear that such a restraint on her will be "reasonable" unless she is also an employee, it may be just as well to rely instead on a prohibition against not only direct but any form of indirect competition.

[17] Mandel indicates that, in addition to formal requirements (*e.g.*, compliance with the statute of frauds, and designation of parties), the agreement should deal with duration, renewal, employee disability, sale or discontinuance of the employer's business, employee's duties, compensation, modifications of the agreement, competition, trade secrets, the uniqueness of the employee's service, treatment of employee inventions, and the option of the employer to cancel

a long-term employment contract possibly with a provision for liquidated damages. L. MANDEL, *supra* note 1, at 161-92.

Obviously, all of these, except possibly the last, are appropriate to all employment contracts including those for persons of the third category. Even the last, if high enough damages are to be paid, may be appropriate in the case of participants.

However, the terms of the various provisions—whether they are employer or employee biased—will differ depending on the category in which the employee falls.

O'Neal states:

> The rights and duties of the parties to an employment contract must be stated fully and carefully if litigation is to be avoided. Among the matters which should be covered are the following: (1) the duties of the employee and his title if any, the place or places where those duties are to be performed, whether the employer may change the employee's duties, his title, or the place where the duties are to be performed, and who is to bear the expense of the employee's moving to a new location; (2) the term of the employment (this must be stated in words that cannot be misunderstood because the courts narrowly construe provisions fixing the duration of employment); (3) the compensation the employee is to receive, the time of payment, and arrangements for bonuses, profit-sharing, deferred compensation, expense accounts, company-funded insurance and other fringe benefits; (4) the amount of time to be given by the employee to the employment, whether he may have other employment, and (if so) any restrictions on the nature of the other employment; (5) provisions designed to protect trade secrets, confidential information and goodwill; (6) limitations (if any) on the employee's future business activities if the employment is terminated; (7) the effect of the employee's disability on the contract and perhaps standards for determining disability; (8) the effect on the obligations of both the corporation and the employee of dissolution, merger or consolidation of the corporation, sale of all its assets, or discontinuance of the activity for which the employee is engaged; (9) perhaps provision for liquidated damages if the contract is breached or for pensions if the employee retires or severance pay if the corporation fails to renew the contract; and (10) provision that any termination or modification of the contract or any waiver of its provisions will not be effective unless it is reduced to writing and signed by the parties (this provision is desirable because the parol evidence rule will not furnish protection against alleged oral modifications of the agreement).

1 F. O'NEAL, CLOSE CORPORATIONS § 6.11 (1971) (footnotes omitted).

He adds that an arbitration clause may be desirable, as well as clauses defining the corporation's right or obligation to repurchase any employee-owned stock on termination, including a method of valuing the shares, and one defining the effect of a breach by the employee on the corporation's repurchase obligation. *Id.*

It is advisable to provide expressly for the effect of mergers, consolidations, dissolution, termination of the business or of the branch in which the employee functions, and sales of the business, in order to protect not only the employee but also the employer.

In the absence of a contrary provision, there is authority that neither the employer's nor employee's obligation will automatically terminate merely because the business is sold, merged or terminated. *See* L. MANDEL, *supra* note 1, and cases cited at 168 n.22; 1 F. O'NEAL, *supra*, § 6.11 (1971) and cases cited at n.9.

However, unless there is provision to the contrary, the employee's employment contract may be considered "personal", and, therefore, non-assignable even to a successor corporation composed of the same persons as the employer. *See* J. CALAMARI & J. PERILLO, CONTRACTS § 18-8 (2d ed. 1977). *Cf.* Wooster v. Crane & Co., 73 N.J. Eq. 22, 66 A. 1093 (Ch. 1907) (reference to contract's bindingness on corporation's successors and assigns not sufficient to prevent rescission by employee).

Without such a provision permitting assignment, even a noncompetition clause in such a "personal" contract may not survive dissolution. Smith, Bell & Hauck, Inc. v. Cullins, 123 Vt.

Where appropriate, *e.g.*, disposition of inventions, the right of the employee to take advantage of "corporate opportunities" in noncompeting businesses, will also be added.[18]

Where the employee is a participant, additional provisions pertaining to the effect of termination as an employee on his director and officer status, and share ownership, and vice-versa should also be added. Thus, for example, if he ceases employment it may well be desirable to require his resignation as an officer and director, and an offer by him of his shares to the other shareholders. The converse, ceasing to be a shareholder (or director or officer), may trigger a termination of his employment contract.

While an agreement suitable to a nonparticipant (which typically will make his duties, and powers, subject to approval by the board of directors) can be used for a participant, especially where he has a guaranteed position on the board and a veto power there with the result that his duties and powers cannot be changed without his consent, the language of the basic provisions discussed above will frequently differ widely from that used for nonparticipant employees.

Although the favorableness of the terms will depend on how valuable the participants believe his services will be, a nonparticipant contract will generally be weighed in favor of the participants through the corporation, and against the employee. Thus, not only will his duties be subject to their control, but he will, despite the contract, normally be dischargable without liability to the corporate employer for specified derelictions or at least "cause."[19]

The emphasis in a participant contract will probably be different. It may well, among other things, make a change in duties and responsibilities impossible without the "employee's" consent, and his

96, 183 A.2d 528 (1962); 16A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8123 (rev. perm. ed. 1979). *See generally* 14 S. WILLISTON, CONTRACTS §§ 1643, 1643A, 1643B (3d ed. 1972); 18 S. WILLISTON, CONTRACTS § 1960 (3d ed. 1972).

It may or may not be desirable to have the contract survive a sale, transformation, *etc.*, of the business. In any event, explicitness as to whether the contract will or will not be assignable is important.

An employee-participant may well be given or possess with other shareholders or independently, the power to cause dissolution of the corporation. The possibility of using this power to escape from his noncompetition clause, and form a competing business of his own, with consequent injury to his co-participants in the old business, should, however, not be ignored when determining the power that will be granted to a participant to force such a dissolution.

Obviously, making his employment contract, and its noncompetition clause, assignable will diminish his power, while making it nonassignable will correspondingly magnify his coercive power over his co-participants.

[18] *See* note 11 *supra*.

[19] *See generally* 9 S. WILLISTON, CONTRACTS § 1012B (3d ed. 1967); RESTATEMENT OF CONTRACTS § 275, comment a, illustration 5 (1932).

discharge as difficult as is legally possible. Forms for nonparticipant employment contracts are readily available.[20] They may, of course, be modified to be more favorable to the "employee." The employment provisions in the shareholder agreement should be drafted to give the maximum protection to the shareholder-employee.[21] Compromises between an extremely employer-biased, and an extremely employee-biased arrangement may be desirable. The terms will ultimately have to be hammered out by negotiation.

III. Special Problem Areas

While care must be exercised in drafting all portions of the employment arrangement, whether for a participant or nonparticipant, certain problems deserve special consideration. These are discussed in the following sections. All are of vital importance in the participant agreement, and may be of significance in the penumbral area of the significant employee who has potential for participant status. At least one, the problem of noncompetition clauses, is important even to contracts for purely second category employees.

A. *Compensation*

His compensation is of primary concern to any employee. Where the amount is fixed by contract, its continued adequacy in an inflationary period like the present will cause special concern to the employee, particularly where the contract term is for a period of years. Where the corporation can afford it, additional compensation can be provided in the form of fringe benefits, of qualified retirement plans,[22] stock ownership plans,[23] or, if the employee has confidence

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[20] *See, e.g.*, C. Israels, *supra* note 7, Appendix B, at 539-47; L. Mandel, *supra* note 1, Forms 18, 19 & 20; B. Becker, B. Savin & D. Becker, Legal Checklists—Specially Selected Forms, Forms 4.1 to 4.4 (1977); 5 J. Rabkin & M. Johnson, *supra* note 15, Form 12.01 to 12.16E. *See generally* A. Seidel & R. Panitch, What the General Practitioner Should Know About Trade Secrets and Employment Contracts (ALI-ABA 1973). Mandel also gives a form of employment agreement for an executive giving him the right to terminate if he is not elected and retained as president and director. L. Mandel, *supra* note 1, Form 21.

[21] *See generally* 1 F. O'Neal, *supra* note 17, §§ 6.05 & 6.14 (as to use of employment contracts as means of protecting participants). As to suggested contents of an employment contract see note 17 *supra*. *See* 1 F. O'Neal, *supra* note 17, § 6.11. For a general discussion of employment contracts, see L. Mandel, *supra* note 1, ch. 5.

[22] *See generally* M. Canan, Qualified Retirement Plans (1977). For a comprehensive discussion of the tax aspects of qualified employee benefit plans, see T. Ness & E. Vogel, Taxation of the Closely Held Corporation §§ 9.21-.29(a) (1976).

[23] *See* I.R.C. § 83. *See generally* T. Ness & E. Vogel, *supra* note 22, §§ 8.51-.57.

in the continued success of the business after his retirement, unfunded deferred compensation plans.[24] In today's economy, however, the promise of future rewards will probably be insufficient to satisfy the employee. He will want an escalation in current compensation as the corporate profits increase, even though such compensation is immediately taxable.

All compensation must be "reasonable," not only to satisfy the requirements of corporation laws, a very minor problem, but, more importantly, to comply with IRS requirements. Treasury Regulation section 1.162-7, although dealing with corporate deductibility of compensation for services, is relevant on the general question of reasonableness of salaries.[25] The IRS regulations provide that all salaries must be reasonable, *i.e.*, not excessive. They also caution of a special danger with regard to participant salaries. Treasury Regulation section 1.162-7(b)(1) states:

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[24] *See* Revenue Act of 1978, § 132, Pub. L. No. 95-600; Rev. Rul. 60-31, 1960-1 C.B. 174, *modified* Rev. Rul. 64-279, 1964-2 C.B. 121, *modified* Rev. Rul. 70-435, 1970-2 C.B. 10.

[25] Treas. Reg. §§ 1.162-8 and 1.162-9 are also relevant. They provide as follows:

> Treatment of excessive compensation.
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> The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

Treas. Reg. § 1.162-8.

> Bonuses to employees.
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> Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

Treas. Reg. § 1.162-9.

But see Pepsi-Cola Bottling Co. of Salina v. Commissioner, 61 T.C. 564 (1974), *aff'd*, 528 F.2d 176 (9th Cir. 1975) (bonus payments computed on percentage of net income, paid to controlling shareholder-president-general manager had become excessive and were to be considered in part dividends). *See also* Locke Machine Co., 168 F.2d 21 (6th Cir. 1948); Northlich, Stolley Inc. v. United States, 368 F.2d 272 (Ct. Cl. 1966).

Although this will not be the sole ground for denying deductibility, it should be noted that the failure of a corporation to pay reasonable dividends may have an adverse effect on the determination that salaries are reasonable. *See* Rev. Rul. 79-8, 1979-1 C.B. 92.

> An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid out for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.[26]

The regulations, while indicating that contingent compensation will not necessarily be disallowed, further warn that "any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise."[27]

Where the employee is in the over fifty percent tax bracket, the reasonableness of his compensation, under the IRS guidelines, will be particularly important to him, since only that part of his salary compensation meeting this test of reasonableness will be sheltered under I.R.C. section 1348 which limits tax on personal service income to a maximum of fifty percent.[28] Where the salary is not significantly out of line with that paid for comparable services in comparable businesses, is arrived at arm's length, and the employee is not also a shareholder, the danger of its being found unreasonable is probably not too great.[29] Yet, where the employee is also a shareholder of a close corporation, the compensation agreement will be subject to greater scrutiny.

It should be noted that reasonableness under section 1348 will be significant from the employee's point of view, if he is a participant, whether or not the corporation has elected Subchapter S tax treatment, since compensation that is too high may be regarded as partially a dividend to him, and hence not subject to the fifty percent limit on the excess over the amount held to be reasonable compensation.

Although in an ordinary tax corporation, the IRS is unlikely to argue that even a shareholder-employee's compensation is too low,[30]

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[26] Treas. Reg. § 1.162-7(b)(1).

[27] Treas. Reg. § 1.162-7(b)(2).

[28] *See* I.R.C. § 1348. *See generally* J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION CODE COMMENTARY §§ 1348(a):1 to 1348(b):1 (1978).

[29] *See* Treas. Reg. 1.162-7(b)(2); 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25.81 (1979).

[30] Too low compensation, with consequent accumulation may, however, give rise to an unreasonable accumulation problem under I.R.C. § 531.

it will sometimes make this argument where a Subchapter S corporation is involved. Under section 1375 (c) of the I.R.C. the IRS has power to reallocate dividends to reflect the value of services rendered where shareholders are members of the same family.[31] The purpose of this provision is to prevent such obvious tax avoidance as a father's setting up a business with his inactive wife and minor children as shareholders for the purpose of splitting income among them. Since the income tax is graduated, *i.e.*, not only the amount but the percent of tax increases the more one earns, such splitting will diminish the overall tax bite on the family group by spreading income among persons who will, as a result, be in lower tax brackets. Because the success of the plan will require diverting as much money to the inactive shareholders as possible, the active father has an incentive to under-compensate himself; hence the IRS argument that dividends to the inactive shareholders are too high because the salary to the active shareholder is too low.

In a non-family Subchapter S corporation, where the employee-participant is in a relatively low tax bracket, however, it will ordinarily not make any difference to him taxwise whether the payment to him is characterized as "salary" or "dividend." The same will be true as to a nonparticipant employee in an ordinary tax corporation.

Disallowance of his salary as unreasonably high will, on the other hand, make a difference to a shareholder-employee in an ordinary tax corporation, since it will, in effect, result in "double taxation" in the sense of a corporate tax as well as an individual one. Thus, the salary, however characterized, will be taxed at ordinary income tax rates to him, and, because disallowed as a deduction on the corporate level, that portion characterized as a "dividend" because unreasonably high will be taxed again, as part of the corporation's income, to the corporation.

Although the existence of such an agreement may make the IRS suspicious as to the reasonableness of the compensation, and hence more apt to challenge it, an agreement to reimburse the corporation for any amounts of his salary held unreasonable will apparently avoid the tax on the shareholder level, and, therefore, because the corporate rates are relatively low, not result in any real disaster.[32]

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[31] I.R.C. § 1375(c). *See generally* 7 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 41B.31 (Cum. Supp. 1980) and cases cited at n.3.

[32] In reference to such "hedge agreements" see Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 1.01 [3] [ii] (1980). *See generally* CLOSELY HELD CORPORATIONS § 6.52 (Ill. I.C.L.E. 1977). The agreement, which should be entered into before the compensation is granted, should create a binding obligation to repay any amounts held to be

Even if the compensation of a participant-employee as originally fixed in the employment agreement avoids IRS objection, attempts to increase it in line with corporate earnings may prove troublesome.

The simplest way of giving a participant-employee adequate compensation would, of course, be to give him a percentage of the corporate earnings by way of a bonus after the business profits for the year have been determined. Although a retroactive bonus, like other compensation voted *after* the services have been rendered, might be challenged under corporate law as lacking consideration, and hence an improper gift of the corporate assets where not all shareholders approve, the arrangement, where bargained for before the services are rendered, should be impervious to attack under the corporation law unless the actual amounts received under the formula become grossly excessive. Even here there is little danger, unless creditors are adversely affected, if all of the shareholders approve the compensation, because of the general rule that unanimous shareholder consent can validate even a gift of the corporation's assets.

The IRS is, however, not so generous. Where compensation is proportional to shareholding and pegged to corporate earnings, it obviously smells like a dividend, and may well be treated as such.[33] This will result in disallowance of a deduction for that portion of the compensation which is determined to fall in the dividend category. This will mean a species of double taxation in the ordinary tax corporation. In a Subchapter S corporation, it may make no difference unless section 1348 is relevant.

While any bonus to participants in a close corporation is suspicious, one based on a percentage of the compensation paid, provided the original compensation of all participants is not itself proportional to shareholdings, may be somewhat safer. If disallowed, however, this may have adverse effects even in a Subchapter S corporation, this time on the participants not receiving the compensation.[34] Since what are properly dividends are taxed to the shareholders propor-

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unreasonable. It should also attempt to negative any inference of unreasonableness (by indicating that it is only entered into on advice of counsel). *See* Rev. Rul. 69-115, 1969-1 C.B. 50, and authorities cited in note 33 *infra*.

[33] *See, e.g.*, City Chevrolet Co. v. Commissioner, 228 F.2d 894 (4th Cir. 1956) (per curiam); Samuel Heath Co. v. United States, 2 F. Supp. 637 (Ct. Cl. 1933). *See generally* 4A J. MERTENS, *supra* note 29, §§ 25.61-.87; 2 F. O'NEAL, CLOSE CORPORATIONS, §§ 8.13, 8.14 (1971); W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 161-65 (1971); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶7.05 at 7-39, 7-40 (1979); T. NESS & E. VOGEL, *supra* note 22, § 8; Annot., 10 A.L.R.3d 125 (1966).

[34] *See* I.R.C. § 1375(c). *See generally* 7 J. MERTENS, *supra* note 31, § 41B.31.

tional to their shareholdings, the disallowed compensation will therefore be reallocated among the other participants, and taxable to them.

In some types of business, adequate compensation, despite increasing profitability and inflation, can be assured by pegging compensation to income generated by the employee-participant. For example, the employment contract of a real estate broker can provide that a percentage of all brokerage commissions earned by his efforts be paid to him. Although the percentage remains the same during the term of the contract, his income under it may increase satisfactorily, and still withstand IRS attack.

Despite tax dangers, some formula for increments will probably have to be utilized where an employment contract is being used to insure a minority participant an adequate financial participation in the business, especially if he is "locked in" by a relatively long agreement, or, even if the term is relatively short, he is still, in effect, "locked in," as is probable, by a noncompetition covenant effective against him if he does not accept renewal of the contract on the same terms upon its expiration.

Provisions might be included for: a percentage increase in the fixed compensation each year;[35] increases pegged to the cost of living (*e.g.*, the consumer price index), as is done in some union contracts;[36] individual increases proportional to those granted to other participants (*e.g.*, "any salary increases for A, B and C shall respectively be in the ratio of 3:2:1"). None of these methods is perfect, since they may still result either in too small an increase, or, on the other hand, one larger than the corporation's income in the particular year would justify.

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[35] In certain businesses additional compensation based on a commission or percentage of earnings generated by the particular employee may survive IRS scrutiny, *see* 4A J. MERTENS, *supra* note 29, § 25.75, and solve the problem. However, any compensation arrangement for close corporation participants that is based on a percentage of corporate profits is dangerous since the IRS may regard it as a disguised dividend.

The following provision, not based on corporate profits, might be considered as a solution:

> Each of the aforesaid salaries shall be increased by ________ percent for the second year; by ________ percent over that paid in the second year, for the third year; and by ________ percent over that paid in the third year for the fourth year, and shall be increased by a like ____________percent each year, over that paid the previous year, for each year thereafter. Payment of said increments will be made ratably, in the same manner, and at the same times as provided above for the initial salaries, and as successively increased for all purposes be substituted for the salaries initially fixed.

Needless to say, the percentages must be carefully chosen to guarantee adequate compensation while at the same time avoiding an excessive burden on the corporation and a charge of unreasonableness by the IRS. This, of course, is not an easy task.

[36] For form, see 5 J. RABKIN & M. JOHNSON, *supra* note 15, Form 12.26, ¶ 2(c).

A provision "for increases as approved by the board" might be used. This will only help a minority participant where not only is he guaranteed a continuing seat on the board (*e.g.*, through a unanimous shareholder agreement to elect and reelect him), but also sufficient power on the board to guarantee a favorable vote for his raise (*e.g.*, through a high vote requirement under which his vote is necessary to fix all compensation), since if he can veto raises to his fellow participants, he can exact a raise for himself as a condition to affirming theirs. This device is not foolproof, however, since it presupposes that the other board members will be equally anxious to have their salaries as employees increased, a situation which may not always be the case.

Power on the board will be especially important when the time for renewal of the contract comes. Again, if all participant contracts expire at the same time, and each has a veto power, there will probably be sufficient protection for each.

It should be noted that, by definition, a nonparticipant employee will not have such power, except possibly through a friend on the board, and will therefore suffer in any negotiations from the weight of any post-employment noncompetition clause against him. He will therefore be well advised, at the time of the initial contract, to try to secure a noncompetition clause as favorable to him as his importance to the business will justify.

Where compensation escalation clauses are satisfactory to him, an employee of either the second or third category will have an incentive to renew his contract where that power is granted to him. This may, however, cause dissatisfaction to the other participants, even though their contracts contain the same escalator provision, where they feel that the employee's efforts are slacking off, and, accordingly, that his compensation will be disporportionate to his service contribution.

Automatic escalation may, of course, pose problems even during the term of the original contract. To qualify as reasonable compensation for tax purposes, the payments must be for services actually rendered.[37] This will also be necessary to avoid dissatisfaction among the other participants who may feel they are "carrying" a participant who, realizing the security of his financial return, has decided to let his efforts slide. Carefully detailed provisions as to the work input to be required of each participant may ameliorate this problem.

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[37] *See* Treas. Reg. § 1.162(a); 4A J. MERTENS, *supra* note 29, § 25.65.

The best solution may be the use of multiple methods: a reasonable fixed salary, plus a modest automatic escalation, and a discretionary bonus based on services, with maxima set.[38] Some danger of imposition on a minority holder is posed by the latter, unless, of course, he has a veto power on the board.

In a Subchapter S corporation, the employment contract will be used as a means of allocating financial participation disproportionate to the cash investment. The minority service participant, even if not fully satisfied with his employment contract compensation, will still share in any after salary profits, albeit only proportional to his stock interest, and, thus may be willing to accept some majority discretion as to additional compensation, especially if any bonus is limited to active service contributors.

The participants may attempt to avoid the tax and practical problems of drafting suitable salary escalation clauses by fixing an amount initially which they consider will be high enough to keep everyone happy for the entire term of the agreement. However, this itself may pose difficult practical and tax problems. The dangers will, as with many of the problems discussed above, vary inversely with the length of time the agreement will run. The first difficulty will be in coming up with the right figure. In a newly formed business, it will frequently be difficult to predict how much income the venture will generate. If the estimate is too low, there will be the same under-compensation problem discussed above. If it turns out to be too high, the corporation may, at best, be unable to pay the compensation on time. This will result in loss of the deduction completely for corporations using the accrual method of accounting (required where inventories are necessary to reflect income correctly) where, as is typical, the employee reports on the cash method, he is not paid within two and a half months after the end of the corporation's tax year, and he and specified members of his family own over 50% in value of the stock.[39] Since, by hypothesis, the salary payments will be generous, even if the special nondeductibility problem can be avoided, the general problem of possibly excessive, *i.e.*, unreasonable, compensation will remain.

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[38] The following could, *e.g.*, be added to the form provision in note 35 *supra*: "However, in no event shall the salary paid to said employee exceed $______ per annum."

The maximum could also be phrased in terms of a set percentage of the compensation originally fixed.

[39] I.R.C. § 267.

B. Noncompetition Clauses

According to Wetzel, "the two fundamentals in drafting a covenant not to compete are (1) fixing minimum restrictions of time and place which will meet the needs of the particular business, and (2) providing for adequate consideration for the covenant."[40]

Although there is an overlap, and, therefore, the provisions may be combined in one clause, it is necessary to distinguish between an obligation as to the time the employee agrees to devote to his duties, and his agreement not to compete during and after employment with the corporation. This applies with equal force to a significant or participant employee.

If he is required to devote his full time to the corporation's business during the term of the contract, competition may well be difficult. However, it may not preclude his acquiring an inactive interest, for example, through stock ownership, in a competing business that he later intends to devote his full time to. Accordingly, especially if he is not to be required to devote full time to the corporation's business, a prohibition not only against competition after, but also during, employment may be advisable.

Generally, noncompetition covenants by the former owners upon the sale of a business are more favored than those in employment contracts. The general rule as to the latter is that they must be reasonable as to scope of activities prohibited, time, and geographic area.[41]

The requirements are interrelated. Thus, a provision restricting competition over a wide geographic area may be reasonable if for a short period of time, a prohibition forever may be reasonable if for a limited area, *etc.* The requirements for reasonableness will differ for different businesses, and the relative importance of the particular employee to the success of the former employer. Guidance as to setting the geographic scope and duration for particular business activities can be obtained by taking the minimum figures upheld in the decided cases.[42] Whether more lax restrictions than these will be imposed will be determined by the bargaining position of the employee.

Although liquidated damages can be provided for, these may be an inadequate remedy. Accordingly, a consent to specific perform-

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[40] Wetzel, *Employment Contracts and Noncompetition Agreements,* 1969 U. ILL. L. F. 61,69.

[41] *See* authorities cited in note 47 *infra.*

[42] *See* authorities cited in note 47 *infra.*

ance, or enforcement by injunction, should probably be provided for, together with a provision that the liquidated damage clause will not prevent such equitable relief.[43]

Some states have statutes making noncompetition clauses illegal.[44] Others have statutes expressly legalizing them under certain conditions.[45] Generally, however, the validity of such agreements is left to common law formulation.

The attitude of the courts towards enforcement of such restrictive covenants in the absence of statute differs. In some states, a mistake as to the duration or scope of the restriction will make the entire covenant void. Other states, like New Jersey,[46] wisely take a flexible

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[43] *See* notes 80-85 *infra* and accompanying text.

[44] *See, e.g.*, CAL. BUS. & PROF. CODE §§ 16600-01 (West 1964); Wetzel, *supra* note 40, at 62-63.

[45] *See, e.g.*, FLA. STAT. ANN. § 542.12 (West Cum. Supp. 1980); Wetzel, *supra* note 40, at 62-63.

[46] *See* Solari Indus., Inc. v. Malady, 55 N.J. 571, 264 A.2d 53 (1970). The court held that a restriction which was for a period of one year, but was not limited in area, was not void *per se* but should be enforced to the extent reasonable under the circumstances.

The court said:

> [P]laintiffs are entitled, subject to any affirmative defenses . . . , to that limited measure of relief within the terms of the noncompetitive agreement which is reasonably necessary to protect their legitimate interests, will cause no undue hardship on the defendant, and will not impair the public interest.

55 N.J. at 585, 264 A.2d at 61.

The noncompetition provision is set out in 55 N.J. at 573, 264 A.2d at 54.

It should be noted, however, that injunctive relief will not be available against a former employee without proof that the former employer is likely to be harmed by the breach. *See* Whitmyer Bros., Inc. v. Doyle, 58 N.J. 25, 274 A.2d 577 (1971).

Hogan v. Bergen Brunswig Corp., 153 N.J. Super. 37, 378 A.2d 1164 (App. Div. 1977), reversing a lower court injunction that prohibited enforcement of the covenant against a discharged employee, held that sufficient consideration for the covenant could be found in a continuation of the employee's employment after he acknowledged, at the employer's insistence, receipt of a letter containing a "policy statement" imposing the noncompetition requirements, even though immediate discharge for failure to sign was not expressly threatened.

The court also stated that "enforcement of such restrictive covenants does not depend upon the existence of a written contract of employment," and summarized the holdings of the *Solari*, *Whitmyer*, and earlier cases as follows:

> An employee's restrictive covenant against post-employment competition ancillary to a contract of employment will be given effect if the covenant "is reasonable under all the circumstances of the particular case" and it will generally be found to be reasonable if it "simply protects the legitimate interest of the employer, imposes no undue hardship on the employee and is not injurious to the public."

Id. at 41, 378 A.2d at 1166.

On the other hand, in Ellis v. Lionikis, 152 N.J. Super. 321, 377 A.2d 1208 (Ch. Div. 1977), *aff'd*, 162 N.J. Super. 579, 394 A.2d 115 (App. Div. 1978) the court stated:

> Were this an action by State [employer] to enjoin Ellis from competing in violation of a post-employment covenant, it is clear State would not be entitled to such relief under the standards laid down in *Solari Industries, Inc. v. Malady*, 55 N.J. 571,

approach, and will enforce the unreasonable covenant to the extent necessary to protect the former employer, cutting down its duration, scope of interdicted activities, and the geographic bounds of the prohibition, to the extent necessary to protect the employer while still not unreasonably imposing on the former employee's right to make a living. New York, on the other hand, after adopting a similarly flexible rule,[47] appears to have retreated to its earlier posture that enforcement will be completely denied unless the services of the employee are "special, unique or extraordinary," or there is a theft of trade secrets.[48]

> 576 (1977), and *Whitmyer Bros., Inc. v. Doyle*, 58 N.J. 25, 32-33 (1971). Ellis did not carry over into his new employment any trade secrets or confidential information, nor were his prior relationships with State's customers of any particular significance in gaining business on behalf of his new employers. In fact, State's sales in his territory increased after his departure. Ellis was simply one more salesman seeking orders in an industry which is admittedly highly competitive, and State's legitimate business interests would not be served by restraining him from competing with it. As noted in *Whitmyer* . . . an employer "has no legitimate interest in preventing competition as such" and in the factual context of this case a noncompetitive covenant would be viewed as unreasonable.

162 N.J. Super. 579, 585, 394 A.2d 115, 119 (App. Div. 1978) (quoting Ellis v. Lionikis, 152 N.J. Super. 321, 327-28, 377 A.2d 1208, 1212 (Ch. Div. 1977).

Nevertheless, the validity of the *Solari* rule has recently been reaffirmed in Karlin v. Weinberg, 77 N.J. 408, 390 A.2d 1161 (1978). That case holds that the *Solari* standards (whether the covenant in question "protects the 'legitimate' interests of the employer, imposes no undue hardship on the employee, and is not injurious to the public") also apply to restrictive covenants in employment contracts among physicians. *Id.* at 417, 390 A.2d at 1166. The court added in a footnote that "a mere personal hardship does not amount to an 'undue hardship,' that would prevent enforcement of the covenant," within the meaning of the *Solari* test. The court equated defendant's "adverse financial consequences"with a "mere personal hardship." *Id.* at 417-18 n.3, 390 A.2d at 1166 n.3.

[47] Karpinski v. Ingrasci, 28 N.Y.2d 45, 268 N.E.2d 751, 321 N.Y.S.2d 1 (1971).

There are numerous ALR annotations on the enforceability of employee noncompetition clauses. *See, e.g., Enforceability, insofar as restrictions would be reasonable, of contract containing unreasonable restrictions on competition,* Annot., 61 A.L.R.3d 397 (1975); *Enforceability of restrictive covenant ancillary to employment, as affected by territorial extent of restriction,* Annot., 43 A.L.R.2d 94 (1955); *Enforceability of restrictive covenant, ancillary to employment contract, as affected by duration of restriction,* Annot., 41 A.L.R.2d 15 (1955); *Validity and enforceability of restrictive covenants in contracts of employment,* Annot., 98 A.L.R. 963, (1935), *supplementing,* Annot., 67 A.L.R. 1002 (1930), 52 A.L.R. 1362 (1928), 29 A.L.R. 1331 (1924), 20 A.L.R. 861 (1922), 9 A.L.R. 1456 (1920).

[48] *See, e.g.,* Columbia Ribbon & Carbon Mfg. Co., v. A-1-A Corp., 42 N.Y.2d 496, 369 N.E.2d 4, 398 N.Y.S.2d 1004 (1977); Reed, Roberts Assocs., Inc. v. Strauman, 40 N.Y.2d 303, 353 N.E.2d 590, 386 N.Y.S.2d 677 (1976); Legal Recording & Research Bureau, Ltd. v. Wicka, 62 App. Div.2d 486, 405 N.Y.S.2d 526 (1978).

The latter case summarizes New York law as follows:

> A restrictive covenant may be enforcible [*sic*] by injunctive relief where an employee's services are found to be unique or extraordinary and the provisions of the covenant to which the employee agreed are reasonable. Those covenants which restrict an employee from pursuing a similar post-termination vocation are disfa-

Of course, an independent prohibition against use of trade secrets[49] should be added to the employment contract, and should help to bolster enforcement if it can be established that trade secrets were actually appropriated, even where the more flexible approach prevails. Similarly, attempts should be made to justify an extraordinary, unique, or special characterization of the employee's services by setting forth recitals showing this or, if this cannot be done, at least having the parties agree that the services meet this test.

Even if the availability of equitable enforcement to the extent necessary to protect the employer's legitimate interests, without undue hardship to the employee, or injury to the public, is conceded, the extent of that relief under the flexible test will still be a

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> vored in the law and enforced only where reasonably limited in time and geographical area "and then only to the extent necessary to protect the employer from unfair competition which stems from the employee's use or disclosure of trade secrets or confidential customer lists."

Legal Recording & Research Bureau, Ltd. v. Wicka, 62 App. Div.2d at 488-89, 405 N.Y.S.2d at 527 (quoting Columbia Ribbon & Carbon Mfg. Co. v. A-1-A Corp., 42 N.Y.2d at 499, 398 N.Y.S.2d at 1006, 369 N.E.2d at 6) (citations omitted).

It must be conceded that a species of cosmic dilemma is posed by the decision to enforce or not to uphold such restrictive covenants. As Blake, *Employee Agreements Not to Compete,* 73 HARV. L. REV. 625, 627 (1960), puts it:

> From the point of view of the employer, postemployment restraints are regarded as perhaps the only effective method of preventing unscrupulous competitors or employees from appropriating valuable trade information and customer relationships for their own benefit. Without the protection afforded by such covenants, it is argued, businessmen could not afford to stimulate research and improvement of business methods to a desirably high level, nor could they achieve the degree of freedom of communication within a company that is necessary for efficient operation.
>
> The opposite view is that postemployment restraints reduce both the economic mobility of employees and their personal freedom to follow their own interests. These restraints also diminish competition by intimidating potential competitors and by slowing down the dissemination of ideas, processes, and methods. They unfairly weaken the individual employee's bargaining position vis-a-vis his employer and, from the social point of view, clog the market's channeling of manpower to employments in which its productivity is greatest.

Id.

However if the statement of the law in the *Legal Recording* case is correct, New York gives scarcely any greater protection than that afforded at common law without any agreement! *See* Arnold's Ice Cream Co. v. Carlson, 330 F. Supp. 1185 (E.D.N.Y. 1971) and cases cited therein. *See also* note 81 *infra*.

For a criticism of the requirement of uniqueness of the employee's services see Blake, *Employee Agreements Not to Compete,* 73 HARV. L. REV. 625, 647 (1960).

For employment contracts designed to protect trade secrets, see A. SEIDEL & R. PANITCH, *supra* note 20, 22-27. Today, where appropriate, specific reference to "computer software" should be added.

[49] Agreements not to compete are distinguishable from agreements not to divulge trade secrets. However, the former are a means of protecting against disclosure of such secrets, especially "know how." A. SEIDEL & R. PANITCH, *supra* note 20, 9.

discretionary matter, and the stronger the showing for relief, the more effective it is likely to be.

The attorney for a nonparticipant employee, of course, will want to have as weak a noncompetition clause as it is possible to negotiate.

While caution will be necessary for participants as well, especially for a participant whose principal contribution will be services, a mutually satisfactory provision for use in all participant contracts should be easier to agree upon, especially where all will be active in the business, all contracts will expire at the same time, and each has a veto power over a relaxation of the terms of his co-participant's noncompetition clause.

Needless to say, since termination of employment will trigger the disadvantageous post-employment prohibitions, the availability of renewal of an advantageous employment contract or the ability to negotiate a better one on expiration of its term becomes of paramount importance.[50]

C. Renewal and Modification

In a non-participant contract, an option to renew on the same terms will give the employee job security. It will, of course, not preclude a threat not to renew, and an insistence on higher compensation or other more favorable terms. Therefore, although desirable to the employee, such a provision may not be wanted by the corporation. Conversely, if an option is given to the employer to renew on the old terms, this swings the balance in favor of the corporation, and

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[50] Because of the non-forfeiture provisions of the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001-1381 (1976), it is probably unwise to provide for a forfeiture of pension rights for a violation of the noncompetition clause. *See* Ellis v. Lionikis, 152 N.J. Super. 321, 377 A.2d 1208 (Ch. Div. 1977), *aff'd*, 162 N.J. Super. 579, 394 A.2d 115 (App. Div. 1978); 14 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 6786.1 (rev. perm. ed. 1980); Comment, *Warning: Anticompetition Clauses in Pension and Profit Sharing Plans Might be Hazardous to Your Corporate Health,* 28 BAYLOR L. REV. 369 (1976); Annot., 18 A.L.R.3d 1246 (1978). *But cf.* Western Elec. Co. v. Traphagen, 166 N.J. Super. 418, 400 A.2d 66 (App. Div. 1979) (garnishment order against husband's private pension funds issued by court upon application of divorced wife to enforce alimony rights held not to violate ERISA).

At least as to other forms of unpaid compensation, an effective coercive device may be to phrase the noncompetition obligation as a "condition" rather than a "covenant," thus, justifying a forfeiture. *See* J. CALAMARI & J. PERILLO, *supra* note 17, §§ 16-22.

It should be noted that under Treas. Reg. § 1.1348-3(a)(1)(i) personal service income sheltered by the maxi-tax "does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract." *Id.*

may not be desirable to the employee. The latter type of option is not too common.

An option to renew given to a participant will give him employment security, *i.e.*, the assurance of continued financial return. His bargaining position for a more favorable agreement may, however, be poorer than that of the nonparticipant employee where his and the other participants' primary financial participation is through such contracts, rather than through dividends. Non-renewal on the old terms may, then, mean complete loss of financial participation, and a "lock in" (a "freeze-in") in an unmarketable stock investment.[51]

On the other hand, as indicated above, if all participant contracts expire at the same time, each participant is on the board, and has a veto over the compensation arrangement of his co-participants he will have the additional negotiating power, unless all agree to renewal on the old terms, to insure a suitable modification of his own arrangement as a condition to approval of the arrangements for the others.

Where a participant is represented on the board, and is not reliant on an employment contract, however, he too will have a veto power if the employee-participant is given one. The result may then be quite different. Since the non-employee participant can veto any new contract, the employee-participant will be forced to "take it or leave it," *i.e.*, renew on the old terms or perhaps find himself "locked in" with a practically worthless investment. Needless to say, if his contract does not provide an option for renewal, the participant-employee's position may be desperate, since he may then be left completely at the mercy of the non-employee participant.

This indicates that the service participant might be wise to insist that the purely money participant be denied a place on the board, taking his participation instead in the form of a non-voting security, *e.g.*, preferred stock, non-voting common, or some form of debt instrument.

Even a majority shareholder may find himself in an untenable position where another participant can veto a renewal of his employment arrangement, or prevent an increase in compensation, if he is party to a shareholder agreement with a longer term than the employment contract provision, since he may find himself compelled

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[51] In order to insure renegotiation of the profit-sharing terms of the agreement, a provision could be inserted in the certificate of incorporation allowing any shareholder to dissolve the corporation at will, after the expiration of the time fixed as the agreement's term or the term of the employment arrangement. N.J. STAT. ANN. § 14A:12-5 (West 1969). This would, however, give the participant enormous "blackmail power."

to reelect as a director the very person who has denied him adequate current financial participation in the business!

Usually, it will be desirable to have the employment agreement provisions expire before the underlying shareholder agreement in order to allow readjustment of the employment terms as economic conditions, and the financial position of the particular corporation, change. The dangers where not all participants have a similar interest in adjusting their employment arrangements equitably is obvious, and must be considered when drafting the other relevant corporate documents.

IV. SPECIAL PROBLEMS OF PARTICIPANT AGREEMENTS

Employment contracts designed to protect the financial return of participants raise special problems in addition to those discussed above. These will be dealt with in the following sections.

A. *The All-Powerful Employee*

The dangers confronting the participant-employee suggest the use of protective devices to make his position inpregnable. Some of these have been mentioned above, but bear repeating: an initially favorable contract, renewable at his option; a position on the board assured by a shareholder agreement wherein all the parties agree to elect him and keep him there; a veto power through a high vote requirement for director action on all compensation arrangements; and, expiration of all participant employment contracts at the same time, so that he can use his veto to secure mutual "backscratching."[52]

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[52] One author, writing on employment contracts for participants, notes the difficulty of drafting a contract that "will be totally insulated from such ploys as a by-law amendment which redefines the nature and duties of a particular office." Zammit, *Assuring Executive Employment to a Shareholder in a Close Corporation Under New York Law*, 44 N.Y. ST. B.J. 487, 488 (1972) (footnote omitted). Accordingly, he suggests consideration of other methods for ensuring enforcement by the participant employee. He discusses the following: arbitration provisions, shareholder agreements, irrevocable proxies, high vote and quorum requirements, and voting trusts as possible means.

Citing the case of Staklinski v. Pyramid Elec. Co., 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959), Mr. Zammit concludes that enforcement by the participant may be available through an arbitrator's decision when a court would not grant specific performance, but correctly cautions that the result is not assured since the arbitrator may always award the inadequate remedy of damages instead. The remaining devices are possibilities to insure the necessary veto power to prevent his ouster.

However, both the irrevocable proxy device and the voting trust are only directly effective on the shareholder level, and, therefore, can at best secure status as a director, and, where permitted, *see* N.J. STAT. ANN. § 14A:6-15(1) (West 1969 & Cum. Supp. 1979-1980); N.Y. BUS. CORP. LAW § 715(b) (McKinney 1963), and upon compliance with the statutory provisions, as an officer. Also, as to the latter status, tenure may still not be completely secure. *See* N.J. STAT.

Naturally, the more favorable the contract initially, the better his position. Thus, if it provides for hefty automatic annual increments throughout any term and renewal, his position becomes even more secure, since even if efforts to renegotiate his remuneration upwards do not succeed, he may still have a satisfactory financial return.

Although Israels[53] suggests against an agreement hiring the participant as an officer, if the agreement also provides that he will hold an office, and he is given broad powers under the bylaws in that capacity, his power will also be augmented. Even if he is not given the power as an officer to enter into a new contract with himself as an employee, he will have a strong bargaining position because of his power over other corporate commitments.

The board will still have the power to fire him as an employee, and, even if he is elected as an officer by the shareholders, the power to suspend him. If, however, he is given a veto power over all hirings, firings, and suspensions, again through a high vote requirement, he will, in effect, become unfirable.

ANN. § 14A:6-16 (West 1969 & Cum. Supp. 1979-1980); N.Y. BUS. CORP. LAW § 716 (McKinney 1963).

These devices will, therefore, only indirectly protect employee status through the power he will possess as an officer or director. Where coupled with high director vote requirements these devices may be of some help.

They are, however, subject to serious deficiencies. Thus, a proxy is typically only irrevocable if "coupled with an interest," *see* N.J. STAT. ANN. § 14A:5-19(1) (West 1969), only uncertainly applicable to an employment contract, and even where expressly authorized to implement such a contract, as in New York, only irrevocable for a limited (three year) period. N.Y. BUS. CORP. LAW § 609(f)(4), (g) (McKinney 1963).

Voting trusts, although of longer duration, *see* N.J. STAT. ANN. § 14A:5-20 (West 1969) (twenty-one years); N.Y. BUS. CORP. LAW § 621(a) (McKinney 1963) (ten years), pose another problem: since new share certificates must be issued to the voting trustee thus making him the record holder, he will ordinarily have exclusive voting rights on all matters. N.J. STAT. ANN. § 14A:5-20(1) (West 1969); N.Y. BUS. CORP. LAW §§ 612(a), 621(a) (McKinney 1963). The trustee, of course, can be directed by the voting trust agreement to vote on other matters as directed by the voting trust certificate holders. The drafting problem would hardly seem worth the trouble, when, presumably, a shareholder agreement will be equally efficacious, and without the time limitations imposed on a voting trust.

A unanimous shareholder agreement may even be more effective, since, provided the impingement on board powers is not too significant, it may even bind the participants as to how they will vote as directors, an advantage not available to the voting trust. Accordingly, in states that favor such shareholder agreements (like New York and New Jersey), it would seem unnecessary to utilize the voting trust device.

See also as to use of shareholder agreements, irrevocable proxies, and high vote provisions as a means of protecting the employment arrangement, 1 F. O'NEAL, CLOSE CORPORATIONS §§ 6.15 to .16 (1971), and § 6.14 (Cum. Supp. 1980).

[53] C. ISRAELS, *supra* note 7, § 4.17.

If all board action must be unanimous, not only can he prevent use of the noncompetition clause against himself, but he can effectively paralyze the corporation by vetoing all decisions.[54]

In an imperfect world, the greater the protection given to him, the less protection will his co-participants have against imposition by him. Airtight protection may mean that his co-participants are saddled with an indolent or even disloyal participant of whom they cannot rid themselves. As usual, therefore, the ultimate terms of the arrangement will be the result of negotiation.[55]

Needless to say, the participant-employee will not want to forego a written employment contract, leaving his employment tenure completely up to a majority of the board, unless, of course, he controls that majority. He may, however, be willing to allow a board majority (*i.e.*, forego his veto power) to determine initially whether he has breached his contract by competing with the corporation, or by failing to devote the time and effort to the business required under that contract, since he will still have his action (or arbitration, if so provided) against the corporation for breach of contract if he is improperly dismissed. His willingness to accept this possible dismissal may be contingent on the availability of a satisfactory arrangement for buying out his entire interest in the corporation.

B. Disposition of Shares

It is probably a good rule of thumb that whenever a participant in a close corporation ceases to be an officer, director, or employee, he should also cease to be a shareholder, and, conversely, whenever

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[54] It should be noted that power to approve employment contracts where the participants are involved can apparently be given to the shareholders under N.J. STAT. ANN. § 14A:6-8(3) (West 1969), where, as will normally be the case, the participants, are directors. N.J. STAT. ANN. § 14A:6-8(3) provides as follows:

> The board, by the affirmative vote of a majority of directors in office and irrespective of any personal interest of any of them, shall have authority to establish reasonable compensation of directors for services to the corporation as directors, officers, or otherwise; provided that the approval of the shareholders shall be required if the bylaws so provide.

Id.

A veto power could, of course, be given on the shareholder level, under N.J. STAT. ANN. § 14A:5-12 (West 1969).

[55] It should be noted that where the same arrangements are made for each participant, any increase or diminution of power for one will mean the same increase or decrease for the other, since they will all be "in the same boat." Thus, each may be willing to take the risk of one of them turning out as lazy or disloyal in order to protect himself from possible removal at the hands of a hostile majority.

he ceases to be a shareholder, he should also cease to be an officer, director and employee.

This will probably be advisable from the point of view of all concerned, the withdrawing as well as the remaining members. Thus, a participant who no longer has the security of financial participation because of termination of his employment arrangement will certainly not want to be "locked in" to a business through a stock interest which will give him no guarantee of return. The remaining participants will not want his continued intrusion in operations especially if he has been given disproportionate power through, for example, a shareholder or director veto provision. The "cleanest" arrangement is a complete break.

Again, a difficult problem of balancing, to insure fairness to all concerned, without giving either side a possible blackmail device, is necessary.

Typically, in a close corporation there will be a mandatory share repurchase arrangement on the death or possible disability of a participant. Because of the difficulty of funding such a repurchase, although a shareholder merely wishing to get out of the venture is usually required to offer his shares to the corporation or his fellow shareholders, or give them a right of first refusal before selling them to an outsider, there is usually no requirement that his fellow participants buy them or cause the corporation to do so. Since there may be no outsider willing to purchase his shares, the withdrawing participant may find that his investment is "locked in." Where he has lost the financial participation given by his employment contract, unless he has enough power potential left (*e.g.*, through a board veto over all management decisions) to coerce them into making the repurchase through the threat of continued interference in the operation of the corporation, the remaining participants will have every incentive to decline the offer, and leave him holding his shares. Of course, the less power-financial pressure they carry, the more difficult it will be for him to find an outside buyer for those shares.

Where his employment contract is cancelled the employee participant could be protected by giving him a right to "put" his shares to the other participants, *i.e.*, give him a contract right to force repurchase at a fair price.[56] The problem here is that it may give a

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[56] It might, *e.g.*, be provided that termination of employment will give rise to a right of the participant to have his shares repurchased (*i.e.*, a mandatory repurchase). Termination of employment could be defined to include death, thereby simplifying the drafting problem. Thus, the mandatory repurchase on death provision could simply provide for a repurchase on termination of employment, including termination by reason of the death of said shareholder.

dissatisfied participant too much power, since all he needs to do any time he wants to force repurchase is to breach his employment contract.

A possibly satisfactory compromise is to give the departing participant, in addition to the right to sell to an outsider should the remaining participants refuse his offer under the ordinary share restriction provisions, a coercive device such as the right to dissolve the corporation unless he is bought out, but condition it on his agreeing to take less than the full value of his shares.[57] The share payment terms, cash or deferred, will again increase or diminish the coercive power of the dissolution threat, although, of course, the amount of the discount from the fair value of his shares the forcing shareholder suffers will be the major factor in determining how effective the weapon will be in his hands. This mandatory buy-out at a penalty to the participant forcing it may be a useful device generally, *i.e.*, even when not tied to termination of employment participation, as a means of resolving any long-standing discord.[58]

C. *Hiring the Participants as Officers*

The authorities usually recommend that participant employment security be achieved through reliance on contracts employing the shareholders in non-officer capacities. Thus Professor O'Neal states:

> The lawyer drafting an employment agreement usually should avoid describing the employment in terms of one of the elective corporate offices. In most instances, it will be preferable to hire the employee as general manager, sales manager, production supervisor, or an executive in some other nonstatutory position, prescribing his compensation in that capacity; and then provide that he will serve without additional compensation as a director if elected by the shareholders, and in any corporate office to which he is elected by the board of directors. . . .
>
> By avoiding reference to employment in terms of statutory officerships, the draftsman perhaps somewhat diminishes the risk that an agreement will be held to contravene a statute conferring management on the directors or a statute, or charter or bylaw clause providing for election of specified corporate officers annually by the directors. Further, in jurisdictions which have statutes stat-

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[57] *See* note 17 *supra*.

[58] Compare, however, N.J. STAT. ANN. § 14A:12-7(8) (West 1969), and N.Y. BUS. CORP. LAW §§ 1104-a, 1118, added by L. 1979, c. 217, under which a minority shareholder who is the victim of oppression by his co-participants can receive the full value of his shares.

ing that a specified officer (e.g., the president) must be a director, the phrasing of an employment contract in terms of a non-statutory position rather than an elective officership deprives the shareholders of a power to frustrate the agreement by refusing to elect the employee to the directorate.[59]

This advice is less exigent in modern jurisdictions like New York and New Jersey than elsewhere, as O'Neal himself concedes in another section of his treatise.[60] Thus, an officer need not be a director in either state.[61] There is also no prohibition against election for a term longer than a year.[62] Contracts for employment as officers are also recognized.[63] Where the appropriate document, by-law in New Jersey,[64] certificate of incorporation in New York,[65] allows election of officers by the shareholders, a shareholder agreement[66] binding the parties to keep named individuals in office should be clearly enforceable, since not an impermissible interference with board powers.

While even a shareholder-elected officer can be suspended by the board for cause,[67] a requirement of board unanimity on this decision can be imposed,[68] and, therefore, if the officer is also a director, as can also be insured by a shareholder agreement, even suspension can be prevented.

A shareholder-elected officer can only be removed by the shareholders.[69] This can be prevented by a requirement of shareholder unanimity on this issue.[70]

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[59] 1 F. O'NEAL, *supra* note 17, § 6.10.

[60] *Id.* § 5.17.

[61] See N.J. STAT. ANN. § 14A:6-15 (West 1969 & Cum. Supp. 1979-1980) and N.Y. BUS. CORP. LAW § 715 (McKinney 1963 & Cum. Supp. 1979-1980) which impose no such requirement.

[62] *See* N.J. STAT. ANN. § 14A:6-15(3) (West 1969 & Cum. Supp. 1979-1980) (no limitation); N.Y. BUS. CORP. LAW § 715(c) (McKinney 1963 & Cum. Supp. 1979-1980) (allowing the certificate of incorporation or bylaws to provide otherwise than for an annual term).

[63] *See* N.J. STAT. ANN. § 14A:6-16(1) (West 1969); N.Y. BUS. CORP. LAW § 716(b) (McKinney 1963).

[64] N.J. STAT. ANN. § 14A:6-15(1) (West 1969).

[65] N.Y. BUS. CORP. LAW § 715(b) (McKinney 1963 & Cum. Supp. 1979-1980).

[66] *See* N.J. STAT. ANN. § 14A:5-21(1) (West 1969 & Cum. Supp. 1979-1980); N.Y. BUS. CORP. LAW § 620(a) (McKinney 1963 & Cum. Supp. 1979-1980).

[67] N.J. STAT. ANN. § 14A:6-16(1) (West 1969); N.Y. BUS. CORP. LAW § 716(a) (McKinney 1963).

[68] N.J. STAT. ANN. § 14A:6-7(1) (West 1969 & Cum. Supp. 1979-1980); N.Y. BUS. CORP. LAW § 709(a)(2) (McKinney 1963 & Cum. Supp. 1979-1980).

[69] N.J. STAT. ANN. § 14A:6-16(1) (West 1969); N.Y. BUS. CORP. LAW § 716(a) (McKinney 1963).

[70] N.J. STAT. ANN. § 14A:5-12(1) (West 1969); N.Y. BUS. CORP. LAW § 616(a)(2) (McKinney 1963 & Cum. Supp. 1979-1980).

Thus, where, as will be the case in an arrangement designed to protect a participant's financial return, the officer will also be a shareholder, his security in the officer position can be pretty well secured. In fact, in New Jersey a participant would seem as safe in his capacity as an officer as that of an employee. This is not quite as true in New York. Section 716(c) of the New York Business Corporation Law provides:

> An action to procure a judgment removing an officer for cause may be brought by the attorney general or by the holders of ten percent of the outstanding shares, whether or not entitled to vote. The court may bar from re-election or reappointment any officer so removed for a period fixed by the court.[71]

While an action by the attorney general is not likely, except perhaps in the case of criminal behavior, an action by other shareholders[72] does pose a danger not present in the case of non-officer employment. It should be noted that the statute does not grant the right to prevent such shareholder action by providing otherwise in the certificate of incorporation. Even here, however, the participant is perhaps given some protection by the requirement that the judicial removal can only be for cause, and even greater protection, despite his possible personal ineligibility for the office, through his ability to veto any successor unacceptable to him, if the election of officers requires approval of the participant in his shareholder capacity. Although this veto power may make his position almost as secure as he would be in an employee position, it is still not quite as safe, since his director veto power over his discharge as an employee is apparently not circumscribed in any way.

For this reason, giving a participant a larger proportion of his financial return as an "employee" rather than an officer, while not so important in states like New Jersey, may still be desirable in states like New York.

It should be noted, however, that if removal does take place, however effected, the officer's contract rights are apparently only protected where the officer has been removed without cause. This is true under both statutes.[73] Needless to say, though, a participant's rights under a contract employing him in a non-officer capacity will only be

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[71] N.Y. BUS. CORP. LAW § 716(c) (McKinney 1963).

[72] In a close corporation a single shareholder will frequently possess the requisite ten percent share ownership necessary to bring the action.

[73] N.J. STAT. ANN. § 14A:6-16 (West 1969); N.Y. BUS. CORP. LAW § 716 (McKinney 1963).

protected where he too has been wrongfully discharged. There is scant authority on what constitutes "cause" for removal of an officer.[74] However, a lesser showing may be required than for an employee.[75] Again, this suggests that in a jurisdiction like New York in which officer removal cannot be forestalled by a high vote requirement, sole reliance should not be placed on a contract providing for officer status as a means of protecting the participant's financial interests.

In any event, a contract retaining the participant as an officer as well as an employee is desirable, as additional security. Furthermore, it may make enforcement of the participant's noncompetition agreement more likely since a higher duty to the corporation on the part of an officer is recognized by some courts,[76] and the possible reluctance to enforce a mere employee's promise because of his unequal bargaining position does not apply to higher echelons of management.[77]

D. *Professional Service Corporations*

There are special problems in drafting employment contracts in professional service corporations. One that especially deserves mention, and necessitates a difference from an ordinary participant employment agreement, is the tax danger of personal holding company status unless the *corporation*, rather than the patient or client, retains the right to designate the employee who will perform the service.[78]

V. Enforcement Problems

Specific enforcement of an employment contract *against* an employee generally will not be granted (after all, there is the prohibition against involuntary servitude in the thirteenth amendment to the United States Constitution),[79] although the result can be achieved indirectly through an injunction against the employee's working for someone else under *Lumley v. Wagner*.[80]

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[74] 2 W. Fletcher, Cyclopedia of the Law of Private Corporations § 356 (rev. perm. ed. 1969).

[75] *See* Campbell v. Loew's, Inc., 36 Del. Ch. 563, 134 A.2d 852 (Del. Ch. 1957) ("planned scheme of harrassment" would constitute cause for removal of director).

[76] Blake, *supra* note 48, at 655.

[77] *Id.* at 661.

[78] I.R.C. § 543(a)(7). *See* Z. Cavitch, *supra* note 32, § 13.03[3] (1980).

[79] *But see* cases cited in F. O'Neal, *supra* note 17, § 605 n.8.

[80] 1 De G.M.&G. 604, 42 Eng. Rep. 687, 689 (1852).

In this landmark case, Johanna Wagner, an opera singer, agreed to sing at plaintiff Lumley's theatre. She also agreed to a negative covenant that she would not perform elsewhere during the period of her contract with Lumley without his written authorization. She nonetheless entered into a conflicting contract to sing for Gye. Although the court would not order specific performance of the contract to sing for plaintiff, it did enforce the negative stipulation not to sing elsewhere.

While even in the absence of such a negative covenant, the employee may be restrained from breaching an exclusive employment contract where his services are unique,[81] the Chancellor in *Lumley v. Wagner* did not ground his decision on the special nature of Miss Wagner's services.

Accordingly, where a negative covenant is present, injunctive relief can be justified, even though the services are not special. Courts are, however, understandably more ready to enforce such employment agreements where unique services are involved. From a drafting point of view it is desirable, therefore, to combine a negative covenant with an acknowledgment by the employee that his services (whatever their nature) are in fact unique and extraordinary. While, because of the discretionary nature of equitable relief, success can never be assured, the more provisions bolstering enforcement contained in the agreement the more likely will be the desired result. For this reason, recitals (the "whereas clauses") should also be used clearly to demonstrate the reasonableness and necessity for the employee's promises.[82]

Nevertheless, the normal remedy will be damages, unless the employee's services are "unique," as in the case of an actor or an athlete.[83] Under certain circumstances, a noncompetition provision will be specifically enforced, which, as a practical matter, may be equally effective.

On the other hand, there is nothing to prevent specific enforcement of the contract against the corporation except the largely discredited doctrine of mutuality—if one side cannot get a remedy, neither can the other.[84]

Consent to such enforcement, and giving an arbitrator the power to order it, will probably be effective to require the corporation to

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[81] L. MANDEL, *supra* note 1, at 186.
[82] *See* Richards, *supra* note 16, 248-49.
[83] J. CALAMARI & J. PERILLO, *supra* note 17, § 16-1 to -5.
[84] *Id.* § 16-11.

keep the employee on (or at least continue to pay his salary) unless there are good grounds for discharge.[85]

It may be wise to make sure that a participant's requirement to offer his shares for repurchase on any intended termination of participation is made to survive, despite what happens with regard to his employment contract, since a breach of the employment contract by the corporation may, otherwise, be held to completely free him from such transfer restrictions.[86]

VI. SUMMARY

For a significant employee, or a participant in the close corporation, a written employment contract can provide not only job security, but a measure of financial participation in the successful business.

Especially with regard to agreements designed to protect the investors in the business, tax dangers, and complex drafting problems are involved.

The reciprocal impact of the agreement term, the compensation fixed, renewal provisions, and noncompetition clauses on one another demand careful planning. The danger of loss of financial participation after the agreement ends coupled with a "freeze-in" of his investment indicates the need for additional protective devices. Therefore, not only must the interrelationship of the various items in the employment contract be carefully negotiated, but the entire arrangement must be integrated with the underlying shareholder agreement (whether or not the employment arrangement is included in that basic agreement), certificate of incorporation, and bylaws. Thus, all of these documents must be drafted together. The corporate structure erected will be the result of the relative bargaining power of the respective participants.

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[85] Staklinski v. Pyramid Elec. Co., 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1969).

[86] Steranko v. Inforex, Inc., 362 N.E.2d 222, 232 (Mass. App. Ct. 1977).