EQUITY OWNERSHIP, FIDUCIARY DUTIES AND EXIT PROCEDURES: SOME THINGS TO CONSIDER WHEN DEALING WITH THE DEPARTING EMPLOYEE

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Even under the best circumstances, dealing with the departure of a key employee is never easy. If the departure was unexpected or is otherwise acrimonious, the situation can be even more difficult. This paper discusses a few elements to be considered when a valued employee is unexpectedly leaving a business and focuses specifically on equity ownership issues, possible fiduciary duty concerns, and procedures to follow in connection with the employee's departure.

I. EQUITY OWNERSHIP ISSUES.

It is quite common for key employees to have some form of equity interest in a closely held business. When an employee abruptly announces that he or she is leaving the business, an owner should not make the mistake of assuming that any equity interest will automatically go away with the departure. To the contrary, an owner who failed to structure the interest properly may find that he or she is in the unenviable position of having an entrenched owner in the business who is no longer working for that business.

Employees can have many different types of purported ownership in a closely held business. Direct ownership, restricted stock grants, stock options, and phantom stock ownership are some of the most common vehicles for employees to own an interest in their business. Regardless of the form of equity ownership, when an employee departure is announced, the wise practitioner will quickly compile and review all of the documents relevant to the ownership interest of the subject employee. Time is important here because many agreements impose obligations on the employer to notify the ex-employee within a certain amount of time after the termination of employment of the employer's election to take certain actions. For example, many shareholder agreements will provide that the employer has the right to repurchase shares owned by the employee, provided that notice of that repurchase is given within a specific number of days after the end of the employment period. Also, many option plans will provide for vested options to be exercised within a certain number of days after the end of employment, and the employer needs to know what to expect in this case. It should not be assumed that options, restricted stock grants, phantom ownership interests and other non-direct forms of ownership will automatically go away when employment is terminated. Many agreements will also provide that the amount to be paid by an employer for the equity of an ex-employee is fixed as of the date of departure, so the employer may need to preserve records and prepare for a valuation of the business. In any event, counsel should receive and review all shareholder agreements, stock option plans, stock option agreements, restricted stock agreements, phantom stock arrangements, etc. Additionally, since corporate bylaws and particularly limited liability company agreements will often contain restrictions on ownership, those agreements should be consulted as well.

If there are not agreements in place that address buy-back rights upon departure, an attorney needs to make the client aware of the implications of this fact as soon as possible, to allow the employer, should it desire to do so, to negotiate some form of repurchase as part of the departure. Again, many small business owners make the mistake of assuming that ownership rights and employment are one and the same, and counsel needs to disabuse the client of this notion quickly. An employer will also need to know what rights an ex-employee would have as an owner, and what duties would be owed to that person. For example, if the entity is a corporation, counsel should advise the owner of a shareholder's rights to inspect the books and records of the entity (*See* Tex. Bus. Org. Code § 21.218). If the entity is a limited liability company or limited partnership, counsel should review the company agreement or partnership agreement to determine any rights that a member or limited partner may have under those agreements. Counsel should inform the employer that an ex-employee can sell his or her interest in the company (including to a competitor of the employer) absent some written agreement to the contrary. Additionally, the employer should be advised of fiduciary duties that may be owed to the former employee in his or her capacity as a holder of an ownership interest in the company (see below for a general description of fiduciary duties).

The paragraph above underscores the need for some form of agreement between an employer company and the employee regarding the employee's ownership in the company. A wise attorney will advise a client of the adverse consequences that can arise where an employee has no restrictions on the company securities that he or she acquires. While a full discussion of a shareholder agreement and its contents is beyond the scope of this paper, counsel should become familiar with the structure of these agreements and consider what features are appropriate for the client's situation. At the very minimum, there should be some form of restriction on transfer, whether in the form of an absolute restriction on transfer, a prohibition on transfers to a competitor, or a right of first refusal in the event that the employee wishes to sell to a third party. As long as these agreements are in writing, they will be enforceable. *See*

Tex. Bus. Org. Code §21.101 *et. seq*. An employer may also want repurchase rights in the event the employee is to lose ownership of the shares as a result of a divorce or bankruptcy. A majority owner may also want to include some form of drag along agreement that would give it the right to require an employee owner to concurrently sell his or her interest in the event that the majority owner was selling its interest. Additionally, there needs to be some form of repurchase right in the event that employment is terminated. These arrangements can take many forms, but typically they will provide that the company has the right to repurchase the ownership interest in the event that the employee leaves the company, and will set forth a mechanism for determining the purchase price for that interest, whether through an appraisal, a formula based on company performance, or otherwise. It is common to have differing purchase price calculations based on the circumstances of the departure. For example, there may be a lower price paid if the employee quits or is fired for "cause", whereas the agreement would provide for a higher purchase price if the employee were terminated without cause (or were to leave for a pre-defined "good reason").

EQUITY OWNERSHIP TAKEAWAYS:

1. If a client is going to have employees who own equity, advise them to get a written agreement in place that contains buy-sell restrictions and repurchase rights upon termination of employment.
2. As soon as possible following termination of the employee, review the relevant ownership documents to determine relevant rights, notice requirements, and valuation needs.
3. Advise the client of its rights and obligations under the documents and help draft relevant notices.
4. If no agreements regarding ownership are in place, make sure the client is aware of the relevant rights and duties involved with having an ex-employee as an owner of the business.

II. FIDUCIARY DUTY ISSUES.

An employee who is also a director, manager, or officer of an entity will have fiduciary obligations that could impact the departure. The general fiduciary duties in Texas are the duty of loyalty, the duty of care, and the duty of candor. See Byron F. Egan, *Egan on Entities: Corporations, Partnerships and Limited Liability Companies in Texas*, §2.6 (May 2016). Corporate officers and directors owe fiduciary duties to the entity and its shareholders. *Id*. Duties of LLC managing members, managers and officers are neither specified by statute nor well-established by case law, but duties of loyalty and care are implied. See Elizabeth S. Miller & Robert A. Ragazzo, Business Organizations §20:39 (3d ed. 2011). Counsel should review the relevant LLC company agreement to determine the scope of fiduciary duties owed with respect to the subject limited liability company.

Even if an employee is not an officer, director or manager, the employee (even an at will employee) may still owe limited fiduciary duties to the employer. The Texas Supreme Court has addressed the scope of fiduciary duty in the context of an agency relationship and concluded that the employee, as an agent acting on behalf of the principal, has a duty to act in the best interest of the employer. *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193 (Tex. 2002). The court in *Johnson* relied on the Restatement (Second) of Agency and concluded that there are limited duties of loyalty owed by the employee to the employer whereby the agent should act primarily for the benefit of the employer in matters connected with his agency. *See also Abetter Trucking Co. v. Arizpe*, 113 S.W.3d 503 (Tex. App.—Houston [1st Dist.] 2003, no pet.). These duties arise when the individual "occupies a position of peculiar confidence towards another. It refers to integrity and fidelity. It contemplates fair dealing and good faith, rather than legal obligation as the basis of the transaction." *Johnson*, 73 S.W.3d at 199.

Texas courts have made it clear, however, that the fiduciary relationship imposed on an employee does not prohibit the employee from preparing to compete with the employer's business. *See Johnson*, 73 S.W.3d at 201; *Abetter Trucking Co.*, 113 S.W.3d at 510; *Ameristar Jet Charter, Inc. v. Cobbs*, 184 S.W.3d 369 (Tex. App.—Dallas 2006, no pet.). An employee has no duty to disclose his plans, may join with other employees to plan a new venture, and may take preliminary steps such as forming the entity, obtaining business permits and securing insurance, all without violating any duties to the employer. *Abetter Trucking Co.*, 113 S.W.3d at 511. The court in the *Johnson* case, however, made it clear that there were certain limitations on the conduct of an employee who plans to compete with the employer. The employee may not appropriate the employer's trade secrets, solicit the employer's customers while still working for the employer or take customer lists. Also, the employee cannot use the employer's funds or employees for personal gain. *Johnson*, 73 S.W.3d at 202.

If it is determined that the departing employee owed fiduciary duties to the company, counsel should analyze whether any duties have been or are likely to be breached by the employee. For example, the duty of loyalty requires that a person act in good faith and not allow his or her personal interest to prevail over that of the corporation. *See Gearhart Indus., Inc.v. Smith Intern., Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). The duty of loyalty includes an obligation not to engage in self-dealing transactions, and not to usurp corporate opportunities. *See Egan*, §2.6.3. If an employee knew that a company was about to purchase a piece of property for expansion, and as part of the departure helped the new employer acquire that property, there may be a breach of the fiduciary duty of loyalty. Additionally, the duty of loyalty could have been breached if the employee disclosed confidential information to the new employer as part of the hiring process.

FIDUCIARY DUTY TAKEAWAYS:

1. While fiduciary duty issues don't automatically arise in connection with employee departures, depending on the circumstances there may be fiduciary obligations owed to the entity and its owners.
2. Counsel should be aware of the basic fiduciary duties and consider whether any of those duties were violated in connection with the employee's departure.
3. While mere planning to compete does not constitute a breach of any duties, as part of that planning employees may not use an employer's trade secrets or solicit an employer's customers.

III. EXIT PROCEDURES.

Every company should have standard procedures in place for dealing with employee departures. *See* 1 Lawrence A. Waks, & Brad L. Whitlock, *Texas Practice Guide—Business Transactions* §2.99 (Thomson Reuters 2017). Once an employee announces that he or she is leaving the employment of the company, it may be prudent, depending on the circumstances of departure, to restrict that person's access to the company premises, to the company's computer systems, and his or her co-workers. A good approach would be to have this policy in place at all times, but provide that it can be waived in the discretion of management. If possible, a designated person, such as the director of human resources (or similarly titled person), should conduct an exit interview with the departing employee. The person conducting the interview should confirm that the employee is not in possession of any of the employer's confidential or other proprietary information, or any physical property of the employer such as keys or access cards, laptop computers, etc. It is a good idea to get a signed affidavit from the employee that he or she is not in possession of any of the above items (see Exhibit A to this paper for a form). The employee should be advised of all amounts that are owed as compensation as of the date of departure, including payment for any accrued vacation or other personal time, and that amount should be paid as soon as possible.

As an initial condition of employment, employers should require employees, especially higher-level personnel, to sign separation agreements upon the termination of their employment. These agreements should include the matters covered in the affidavit mentioned above. If the employer wishes to pay severance amounts above and beyond what was actually owned, or if the employer has negotiated an extension of time for exercising options or granted other accommodations whether with respect to equity ownership or otherwise, the employer should consider getting a full release from the employee as consideration for that severance payment or accommodation. Also, counsel should be aware of the time periods for considering (21 days after presentation) and revoking (7 days after signing) an age discrimination release. *See* 29 U.S.C.A §626(f)(1).

Care should be taken to make clear that the nothing in the separation agreement is meant to impact whistleblower protections. Counsel should consider adding language like the foregoing:

> Nothing in this Agreement, including without limitation the confidentiality provisions hereof, prohibits any party from reporting possible violations of any federal, state, or local law, regulation or ordinance to any governmental agency or entity, or making disclosures that are otherwise protected under the whistleblower provisions of any applicable law or that otherwise protect communications from retaliation. No party shall be required to obtain the prior authorization of any other party to make any such reports or disclosures, and no party shall be required to notify any other party that such reports or disclosures have been made. Nothing in this Agreement shall be deemed to prohibit any party from recovering monetary relief under nay whistleblower provisions of applicable law.

Finally, the employee should be advised of all post-employment obligations that may exist, including any applicable non-competition, confidentiality and non-solicitation restrictions that may exist. If these restrictions cannot be conveyed in an in-person interview, the employer or the attorney should send a letter to the employee that lists all of the relevant restrictions. To avoid any claims of unfair interference with an employment relationship, the employer should not, unless it is aware of actual or imminent violations, to contact the ex-employee's new employer and to advise them of the restrictions.

EXIT PROCEDURE TAKEAWAYS:

1. An employer should have standard policies in place regarding how to deal with a departing employee. These policies should include restrictions on access to the premises and IT systems and requirements for an exit interview and a separation agreement.
2. The exit interview should be comprehensive and should cover employee possession of company materials and post-employment obligations.
3. If possible, the company should obtain a separation agreement that includes, among other things, a full release from the employee of all claims against the employer.
4. If not covered by the release agreement, the company should obtain an acknowledgement by the employee in a form similar to that attached as Exhibit A that the employee is not in possession of company materials.