

Employment Pitfalls Part 1

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STARTING UP: *Practical Advice for Entrepreneurs*

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Employment Pitfalls: Part 1 Independent Contractors, Offer Letters, Noncompetition Agreements, Confidentiality Agreements, Payrolls

When I graduated from M.I.T. some thirty years ago (how time flies) my first job was as the third employee of a startup company in Cambridge (some things don't change). Life seemed simple then - I worked long hours programming on a mainframe computer (PCs did not exist) and they paid me a weekly salary. New England was losing textile and shoe factories to the Southeast, the unemployment rate was high and a few (very few) high tech companies were being formed. There was no legal specialty called "Employment Law" (the closest area was Labor-Management Law-union stuff). Today much has changed, especially in the employment area.

There hopefully comes a point in the development of an entrepreneur's business when he or she has to hire or retain others to do some of the work. Since the main assets of most high tech companies go home at night (or perhaps work all night), getting the employment thing right is critical for the success of the venture. Here is a partial checklist of legal things to think about when paying others to do work for you:

Employee vs. Independent Contractor. Employers pay payroll taxes, Social Security/FICA and unemployment taxes on employee salaries. If you hire independent contractors then these taxes are primarily the responsibility of the contractor and the effective tax rates are lower. For this reason the Internal Revenue Service looks very carefully at whether the relationship is an employer/employee one or truly that of an independent contractor. There are 20+ factors that the IRS uses in this determination, including whether the person has multiple clients (looks like an independent contractor) or only one client (looks more like an employee). If you do use an independent contractor be sure you will own the copyrights and other intellectual property produced by the contractor. In general, copyrightable works produced by independent contractors are owned by the contractor even if you pay for the work to be done - unless you get an assignment of the work. On the other hand, an employer owns the copyrightable work authored by an employee in the course of his or her employment.

Offer Letters. In general the employer wants the employment relationship to be "at will", meaning that the employee can be fired as needed. Avoid offer letters that imply long-term commitments - unless that is what you want to do. For example, one startup company hired a number of people using offer letters that offered various positions "for five years". Because the aggregate salaries offered amounted to well over \$1m, the venture capital investors required those situations to be cleaned up, which entailed some current cost to the company. If offer letters are used, the compensation should be stated on a monthly or weekly basis instead of a yearly salary. In addition, consider the use of "probation periods" before any major benefits or equity participation is permitted.

Noncompetition Agreements. These agreements are always tricky from a legal and business viewpoint. These are generally enforceable as a legal matter in Massachusetts if properly drafted

and limited in time, scope and geographic area - in California they generally are not enforceable. However, from a business viewpoint some companies hesitate to impose these agreements because they may be perceived negatively by the valuable potential employee. If you decide to go with non-competition agreements then the best time to have them signed up is as a condition of getting the job in the first place. One of the first things a lawyer looks at when trying to get a client "out from under" a non-competition agreement is whether any consideration or compensation was given in exchange for the agreement- and the job itself certainly is good consideration.

Confidentiality Agreements. Although an employee has a duty to keep confidential his or her employer's confidential information, it is a good idea to have employees sign an agreement which states the obligation clearly and also covers confidential information given to the employer in confidence by third parties. Independent contractors don't have any common law duty to maintain confidentiality, so be sure to have all contractors sign an appropriate confidentiality/nonuse agreement.

Payroll and Taxes. Because of the complexities of the rules, many companies use outside vendors to do payroll and send in the proper withholding taxes to the IRS and the state. The officers of the company having responsibility for paying payroll and withholding taxes may be held personally liable if these are not paid. In Massachusetts because a bank may not attach payroll accounts, be sure to use the word "payroll" in the account title, otherwise the officers may incur personal liability if the payroll is not paid due to a bank having set off an account.

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