



## Employment Contracts: Key Issues for Entrepreneurs



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# Employment Contracts: Key Issues for Entrepreneurs

## Preliminary

If you are an entrepreneur with a controlling interest in the share capital of your company you may never have bothered with a written employment contract. Legally, though, all employees should be issued with one covering more than 20 statutory requirements.

Perhaps though you are contemplating a share issue that will take you down below 50% of the voting share capital. Alternatively you may be one of several entrepreneurs who control the company between you; each of you is a minority shareholder. In that situation you may well think that an employment contract will provide protection for the company but also a measure of protection for each minority shareholder.

Alternatively you may be an entrepreneur faced with a sale of your company at a price that is too low to give your family security. Part of the deal may be an extended period of employment which may include a significant earn out or bonus that needs to be protected.

You may be an entrepreneur looking to build your team with significant equity incentives. In that situation you may want to insist that new service agreements to protect the company's position are signed to reflect a long term commitment each way.

Faced with a long legal template service agreement it is all too easy to fail to spot the wood for the trees.

This fact sheet identifies the key issues on which you should concentrate if you are looking to protect an exit.

## Notice Period

Employee legislation lays down a minimum statutory notice period for employees: this is 12 weeks for long serving employees. Perhaps for this reason 3 months has become the default notice period for most senior employees.

However, notice periods of 6 months or 12 months are not unusual. If you are selling a company on a 2 or 3 year earn out you will probably want a fixed term

employment contract that runs for the same period.

Why does this matter? Well the starting point for any compensation claim is how long did the contract have to run. The initial calculation will then be your net take home pay for that period together with the cash equivalent value of the benefits in kind under the contract.

A point to remember though is that there is an obligation to find another job if you are dismissed: this is called *the duty to mitigate your loss*. For a younger employee in a buoyant marketplace this may very significantly reduce his or her compensation claim.

For a very senior employee (or someone on a very high salary) a long notice period or fixed term can be very significant in any negotiations over compensation. This is because mitigation is much less likely to be a factor, as finding a similar position will be much more difficult and perhaps impossible.

## Job Description and Duties

If you are the employer you will want to have the flexibility to change a job description and perhaps move someone else to do a job jointly with a particular person. If you are the employee and a senior person who has built a company, this may make your position quite untenable. So you will want to resist such changes and specify in the contract that your prior written consent is needed.

## Mobility Clause

The employer may well like the flexibility to move an employee to a new geographical location either in the UK or overseas. The entrepreneur employee will want to insist that any such change requires his consent.

It is not unheard of for a large corporation to use a mobility clause to force out a senior employee: it may be known that there are family commitments which will make relocation very unattractive.

## Remuneration

If a bonus payment is going to be a significant part of the remuneration then

a key question will be whether this is a contractual or non contractual commitment.

Even a non contractual (i.e. discretionary) bonus cannot be operated capriciously. If it is and this can be proved, compensation that reflects the expected bonus may be payable. However, for an entrepreneur looking to protect his or her position a contractual entitlement with a clear written bonus plan should be the starting point. In practice it may be that the business goals can only be set for 12 months but this need not prevent a contractual bonus being agreed albeit subject to new targets in future years to be set by agreement.

## Sickness

For junior employees or early stage companies the employment contract will frequently state that pay (beyond statutory sick pay) is entirely discretionary.

However for established companies it is not unusual to see contractual sick pay entitlements of between 1 month and 12 months for senior employees.

These may be coupled with a permanent health insurance policy that pays either 50% or 75% of basic pay after a specified waiting period. This waiting period might be 3 months or 6 months and should ideally dovetail with the contractual sick pay obligation.

## Pensions

Most pensions are now money purchase rather than final salary. Company contributions of 5% to 10% of basic salary are not uncommon.

## Other Benefits

Other benefits may include a car allowance or mileage allowance: this is more common now that the provision of a car gives rise to tax on a car as a benefit in kind.

Another key benefit will be medical expenses insurance and a question will be whether this extends to your spouse or civil partner and children under 18.

## Restrictive Covenants

A key protection for you as an employer

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may be restrictive covenants, particularly for customer-focusing employees.

Clauses may include: a general non-compete by reference to a type of business and a geographical area; customer non-dealing; customer non-solicitation; potential customer non-solicitation and employee non-solicitation. Protection of suppliers' contracts may also be important depending on the industry.

The starting point is that these clauses are void as being an unlawful restraint of trade. However the courts will enforce them if they do no more than protect the legitimate business interests

of the employer and they are reasonable in all the circumstances. This means having relatively short periods of restriction and limiting the clauses geographically and in terms of scope by reference to the actual business.

As a rule of thumb a restriction should last no longer than the relevant notice period (less any period of garden leave – see below).

### **PILON and Garden Leave**

If you are an employer faced with a non-performing employee or someone who has decided to leave it is likely you will not want him or her to serve their notice period.

You will improve your legal position if you reserve the right to ask the employee to stay at home (so called garden leave). An alternative protection is a clause that allows you to make a payment in lieu of notice (a PILON clause) and ask the employee to leave immediately.

The PILON or garden leave clause ensures that you the employer have not breached the employment contract by not allowing the employee to work his notice. This is important because otherwise the restrictive covenants will be unenforceable.

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