

CHAPTER 10

The Employment Relationship in the Internet and Tech Sectors

Google is interviewing candidates ... who are willing to relocate, are in top physical condition and are capable of surviving with limited access to such modern conveniences as soy low-fat lattes and a steady supply of oxygen. Google will be conducting experiments in entropized information filtering, high-density high-delivery hosting (HiDeHiDeHo) and de-oxygenated cubicle dwelling.

—Excerpt from Google’s Job Opportunities page: http://www.google.com/jobs/lunar_job.html

We need to be both innovative and resilient to succeed in a future where uncertainty will be the new normal.

—Index of Silicon Valley 2010, p. 67 (published by the Joint Venture Silicon Valley Network)

Everything we should be celebrating and preserving ... open immigration, educational excellence, a culture of innovation and a financial system designed to promote creative destruction.

—Thomas Friedman, Op-Ed, “The Spies Who Loved Us,” New York Times, July 13, 2010

LEARNING OUTCOMES

After you have read this chapter, you should be able to:

- Understand how the Internet and Web have changed the dynamic of the employment relationship.
- Learn about the different worker status of employees that exist in just one company.
- Understand how the employment relationship is governed by a variety of laws as well as private agreements between the parties.

Introduction

The employment relationship in the Internet and technology sector is highly dynamic, dominated by creative and talented individuals, where rapid deployment of the technology is mission-critical, strategic assets are as much the technology as the individuals themselves, and changes in company ownership are the norm. The tech and network sectors are dominated by knowledge workers who are highly educated and mobile, often

with multiple cultural links and, as “digital natives,” in comparison to their managers, bankers, consultants, and investors, are way ahead of the curve on technology adoption and uses. Managing these employees and this dynamic employment relationship is a core challenge for tech businesses. Another aspect of the tech sector that the Internet and Web have changed dramatically is the workplace itself. Complicated information and data projects can be disaggregated, then collaboratively designed and completed across distributed asynchronous locations, and finally reaggregated for the client. Work and workplaces are more mobile and unstructured (work gets done at the beach, at WiMax-enabled coffee shops, etc.); work and nonwork tasks are accomplished seamlessly throughout the day. Finally, the ability to move work out of the office network has created unparalleled threats to company assets as work is emailed to personal accounts, workers write blogs about their work environments and their coworkers, and more. The workplace has undergone radical changes with notable losses of control, hierarchy, and secrecy. This chapter surveys the employment relationship in the tech sector along with discussion of agreements between employers and employees common to Internet and technology companies.

The Work Environment

The Preemployment Term

Employer Search for Qualified Candidates Employee search, screening, interviewing, and hiring are special challenges in the high-tech sector, forcing employers and start-ups to confront topics ranging from immigration and visa issues to questions over compensation and stock options, as well as complications with candidates locked into noncompete and other agreements with previous employers. Even after candidates have survived a vetting process, unexpected financial constraints could arise and therefore the position is reclassified as work for a subcontractor, temp, or even an unpaid intern; or the candidate is asked to take stock in the company in lieu of salary as compensation. Further and more extremely, candidates might take photos during a tour of the workplace and post these as well as comments about the interview process.¹ Other candidates may balk at an offer unless a spouse is guaranteed a job placement as well. Still others may want to accept a job offer, but perhaps an unwritten understanding exists between the former and prospective employers to not hire each other’s workers. There are lots of considerations for all parties during this process, in which each company is now competing with the rest of the world’s companies for the top talent. Related to this intense competition are the high-profile company perquisites that act to brand and distinguish companies as they compete for talent. Company perquisites may include: onsite medical care, salons, laundry, massage, game rooms, cafeteria, transportation, pool, gym, referral bonuses, child care, doggie day care, reimbursement for education, stock ownership plan, retirement plan, sabbaticals, surfboards, volleyball courts, bike trails, tickets, even home office reimbursements.

At the outset, it is advisable for employers to create a profile including a job title, description, educational and professional licensing credentials, skill set, and necessary experience. Employers searching for tech professionals will start the search with their professional and personal networks, and perhaps engage professional recruiters. (An Employer’s Guide to these points is featured in Appendix 8.) At this point, promising

¹See “My Interview and Job Offer from Google,” by Pete Abilla, March 29, 2006, <http://www.shmula.com/31/my-interview-job-offer-from-google>.

EXHIBIT 10.1 Questions Candidates were Reportedly Asked when Interviewing at Google

- Q: How many golf balls can fit in a school bus?
- Q: How many times a day does a clock's hands overlap?
- Q: You are at a party with a friend and 10 people are present including you and the friend. Your friend makes you a wager that for every person you find that has the same birthday as you, you get \$1; for every person he finds that does not have the same birthday as you, he gets \$2. Would you accept the wager?
- Q: You are shrunk to the height of a nickel and your mass is proportionally reduced so as to maintain your original density. You are then thrown into an empty glass blender. The blades will start moving in 60 seconds. What do you do?
- Q: Explain a database in three sentences to your eight-year-old nephew.
- Q: How many gas stations would you say there are in the United States?

candidates may be investigated; at a minimum there is a cursory online search including social networks. Those who meet the minimum criteria may be asked to meet initially by telephone, produce a mock work sample, and so forth. If the process merits moving forward, that is, if there is sufficient interest on both sides, candidates will be brought in for a site visit. Candidates will first need to read and agree and sign a **visitor's confidentiality and nondisclosure agreement**. In such contracts, all visitors (including interviewees) promise, in consideration for being admitted to the workplace, to not disclose any information about the company, its employees, or their impressions thereof for a defined period of time. During this visit, candidates interview with a number of constituencies at the workplace. Interview questions must comply with all laws regarding queries on age, citizenship, national origin, religion, disability, and so forth. If everything checks out, including references, companies will transmit an offer letter of employment. Offers are typically conditioned on the candidate's employment eligibility and acceptance of a number of terms, including many of the agreements set forth below. Nevertheless, without regard to employee status, all employees are contractually bound by official policies featured in company handbooks. Handbooks outline the overall guidelines and specific codes for appropriate behavior, dress, communications, and so forth, discussed in more detail in the following.

Problems can potentially surface at any time during this process, particularly when candidates face two impediments. First, employers may be limited in hiring candidates to the extent these candidate employees are still bound to a legally recognized noncompete agreement. (This was mentioned in Chapter 7 with further detail following in the section "Employment Agreements" of this chapter.) Employers should not make any assumptions in this area. It may seem possible to pay off the former employer for costs associated with an employee's departure, but in certain instances the competitive disadvantage is too great and therefore merits the equitable remedy of an injunction prohibiting the employee from assuming certain job duties for a defined period of time at the prospective employer's company. Injunctions are a powerful counterpoint to employee mobility.

Second, employers may be limited in hiring candidates to the extent the employers have agreed among themselves to not hire each other's employees. In the ultra-competitive high-tech market where there is a constant struggle for skilled workers, it is widely reported that companies have unwritten agreements to not actively hire

employees of companies that partner or have joint ventures with each other.² (Hiring employees from *direct competitors* is not an aspect of this legal issue.) Often called *no poaching agreements* or *hands-off lists*, accounts are that the Department of Justice is actively pursuing confidential investigations of the Software, Internet, Technology, and Biotech industries for evidence of anticompetitive acts in violation of the antitrust laws because such agreements, if proven, amount to collusion in hiring decisions that have the effect of restricting job mobility and suppressing wages. Agreements to hold down labor costs are as anticompetitive as agreements to fix prices. Targets of requests for information reportedly include Apple, Genentech, Google, IAC/InterActiveCorp., IBM, Intel, Microsoft, and Yahoo.

The cases in this practice area are guided by *Todd v. Exxon Corp.*³ In an opinion written by then-circuit court Judge Sonia Sotomayor, the court ruled that plaintiff-employees adequately pleaded a Sherman Antitrust Act violation against Exxon and thirteen other companies in the integrated oil and petrochemical industries for colluding in their hiring decisions for oil geologists and petroleum engineers. Specifically, defendants controlled 80–90 percent of the industry’s revenues and employed 80–90 percent of the industry’s workers, and they exchanged a broad range of employment and salary data, including past and current salaries along with future salary budget information. This data was aggregated and distributed to third-party recruiters confidentially without being distributed to the employees themselves, even though the companies allegedly participated in numerous meetings to share this data. The court ruled that the companies had monopoly power and engaged in monopolistic acts that were anticompetitive and lacking in any pro-competitive benefits or impacts.

It is extremely difficult for candidates to discern the existence of such agreements, and what the exact nature of the impact is to their job search. Recruiters and human resource consultants are peripherally impacted by these alleged practices as well.

Employer Verification of Employment Eligibility The high-tech work sector is characterized by a multinational and extremely mobile workforce. It is common for employees to have been born in one country, schooled in another, and then later to seek work in yet a third country. Sorting out employment eligibility is an involved process for human resource departments and daunting for start-ups operating in a garage without the benefit of staffing support services. It is the employer’s responsibility nevertheless to verify that the employee is eligible to work in the U.S. Employers must certify this through completing Form I-9 with the employee. To understand this in more detail, a government publication on employment eligibility is reproduced in Appendix 9.

Employment opportunities in the U.S. are nearly unparalleled, and this promise, along with associated constitutionally recognized freedoms, are historically the reasons for the appeal of pursuing employment in the U.S. These same qualities, too, are cited as support for the U.S. dominance in start-ups, innovation, and invention. Under the current rules, employers may hire only those individuals legally entitled to work here: citizens and nationals of the U.S., lawful permanent residents, and aliens authorized to work, or they will be subject to criminal penalties.⁴ This practice area is hotly debated currently and will likely be changed based on the current political and economic climate. Employment and immigration issues are regulated by two departments: Department of Justice and Department of Homeland Security, along with three agencies: Immigration

²See Thomas Catan and Brent Kendall, “U.S. Steps Up Probe of Hiring in Tech,” *Wall Street Journal*, April 9, 2010; Miguel Helft, “Unwritten Code Rules Silicon Valley Hiring,” *New York Times*, June 4, 2009.

³275 F.3d 191 (2d Cir. 2001).

⁴See 8 U.S.C. §§ 1101–1537 (2012); 8 C.F.R. § 274a (2010).

and Customs Enforcement, Citizenship and Immigration Services, and Customs and Border Protection. Clearly compliance with U.S. immigration laws is a complicated process for employers.

Employer Classification of Employee Status Should the employer decide to hire an employee, it is the employer's responsibility to negotiate the terms and conditions of employment including: pay, responsibilities, hours, and job classification, and whether it is a permanent full-time job, on a contract basis, or based on some other arrangement. The different work configurations made possible by the Internet and Web are astonishing, and it is important to be clear in this nontraditional work environment on what is the status of workers. No longer does work have to be performed by workers simultaneously working in one office. Knowledge work can theoretically be performed anywhere with everyone. Under these conditions therefore, workers might be employed by the company, or self-employed, or even employed by another company—perhaps the main company's supply chain partner halfway around the world. The classification of workers becomes relevant to the obligations employers have, and therefore a short description of each employment classification is provided in this section.

Finally, no matter what the worker classification, most employees in the U.S. are at-will, meaning that either party may sever the employment relationship at any time without liability. Employers may discharge employees for no reason,⁵ and employees are free to depart at anytime. This at-will status as the default arrangement is in stark contrast to similar economies, notably the EU countries, that have established a model defined by employer obligations and employee right to work. The U.S. model serves employers better in that they are freer to take on risk or shed employees. The associated churn is a signature response to economic and market conditions. This further acts as a catalyst for employees to upgrade skills and for employers to seek and capitalize on opportunities. The EU model serves employees better and may cause employers to hesitate in taking on risk because fixed costs are much higher with such amenities as lifetime employment.

Executive/Officer Employees These employment relationships are governed by an **executive employment agreement** (detailed in the section "Employment Agreements"). Officers are responsible for the daily activities and operations, signing major deals, and developing strategy. They act under the direction of the board. Officers are agents and fiduciaries of the corporation (which is owned by the shareholders) and are charged with acting in the best interests of the business and scrupulously avoiding conflicts of interest (these points are more closely covered in Chapter 3). Though they have a contract with the corporation for professional services, unless a defined term is provided in the contract, officers too are at-will employees of the business.

Permanent Nonofficer Employees **Permanent nonofficer employees**, such as managers, staffers, engineers, accountants, project and team leaders, and so forth, execute the plans and strategy of the executive team and board. Companies have the right to control work, pay, and benefits of employees. There are a number of reporting and compliance responsibilities for these employees as well. With regard to permanent employees, companies are required to withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to employees.

⁵There are some legal constraints to the at-will doctrine that act to limit employers' rights to fire employees, including if such discharge violates public policy. See David P. Twomey and Marianne Moody Jennings, *Business Law*, pp. 805–10 (3d ed., 2011).

Self-Employed Professional Subcontractors and Work for Hire Professionals

Subcontractor Professionals **Subcontractors** are nonemployee workers who perform defined tasks for a client company, but remain independent from the client and maintain a separate professional identity with the right and ability to work simultaneously for any other client companies. This class of workers includes outside attorneys, accountants, auditors, and so forth. Client companies have immediate access to qualified workers and reduced overhead expenses, but there is not the same ability to control these workers as they are contractors, the pay rates may be variable, and there is a risk of loss of sensitive business information or trade secrets.

There are fewer compliance and reporting responsibilities for client companies that hire independent contractors. Companies do not have to withhold or pay any taxes on payments to independent contractors. Should there be any question over worker status, companies file a Form SS-8 to determine worker status, responding to such queries as behavioral and financial control over the worker and the benefits, if any, extended to the worker. Generally, the more control a client company exerts over the person, the more likely it is that the IRS will classify the person as an employee.

According to the IRS,

Facts that provide evidence of the degree of control and independence fall into three categories:

- **Behavioral:** *Does the company control or have the right to control what the worker does and how the worker does his or her job?*
- **Financial:** *Are the business aspects of the worker's job controlled by the payer? (These include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)*
- **Type of Relationship:** *Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?*

Businesses must weigh all these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate that the worker is an independent contractor. There is no “magic” or set number of factors that “makes” the worker an employee or an independent contractor, and no one factor stands alone in making this determination. Also, factors relevant in one situation may not be relevant in another. The keys are to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination.⁶

Known as *1099 workers* (in reference to the IRS Form 1099-MISC), companies are required to submit a Form 1099 for every contractor paid more than \$600 in a calendar year. Mistakes in misclassifying workers will have negative financial consequences for companies with liability for back taxes, penalties, and interest, even when the contractor paid taxes in full.

Clearly this work arrangement is very attractive for companies in start-up mode. In an interesting phenomenon, tech workers reportedly embrace their contractor status and wish to remain self-employed. However, Congress enacted the Tax Reform Act of 1986,⁷ and one provision in particular, Section 1706, targeted tech professionals as it

⁶See Stephen Fishman, *Working with Independent Contractors*, pp. 14–15 (6th ed., 2008) (citing as the key determinant for employee status the employer's right to control, or tell the employee what to do).

⁷“Independent Contractor or Employee: How the Process Works Today,” *The CPA Journal*, March 2009, <http://www.nysscpa.org/cpajournal/1999/1299/f261299a.html>; Harvey J. Shulman, “Our Low-Tech Tax Code,” Op-Ed, *New York Times*, February 21, 2010.

tried to reclassify more workers as employees than independent contractors (on the theory that this class of professionals was disproportionately underreporting earned income)—even though tech workers generally favored independent status and reported earned income in higher proportions than other classes of contractors. Should there be any tax reform initiatives, repeal of Section 1706 will surely be on the short list for action. In a Report to Congress, as early as 1991, the Treasury Department released a study highlighting the failings of this regulation, going so far as to describe the “chilling effect of Section 1706 on the ability of technical services personnel to get work.”⁸

During the 2010 legislative cycle, Congress passed health care legislation and included provisions related to 1099 workers that dramatically expand reporting requirements for client companies, which takes effect January 1, 2012.⁹ The IRS is not even sure how it can handle all these changes, and pursuant to this, published a request for *Public Input on Expanded Information Reporting Requirement*.¹⁰ According to the IRS, the law “will require businesses to report a wider range of payments to contractors, vendors and others,” noting that this will be an enormous burden and compliance cost for small businesses.

Self-employed professionals are also pursuing legislative changes in states. For example, in Massachusetts where there is a high proportion of tech professionals engaged in creative work, there is currently a significant amount of lobbying and legislative activity. Featured as part of Senate Bill 2345, *An Act Relative to Economic Development Reorganization* (2010), Amendment No. 4 supports independent contractors by making it easier for businesses to classify workers as such. The bill would modify the current treatment of professionals as interpreted by enforcement actions under Mass. Gen. Laws Ann. Ch. 149, Section 148B (2008).

Work for Hire Professionals A related work arrangement involves work for hire. **Work for hire** is an issue that is quite common to tech start-ups in which companies need software, coding, documentation, and so forth, and for these defined needs, a professional completes the task. Usually after-the-fact questions surface as to ownership of that work. Does the worker (who may be an employee or an independent contractor) own the work? Or does the company?

In cases where the work is performed by an employee within the scope of employment, it is considered a work for hire and the employer is considered the author and therefore owner of that work. All ownership rights, including copyright, credit, and right to control that work, vest in the employer.¹¹

Even construing who is an employee can be difficult in some instances, and courts look for certain factors that characterize the employer-employee relationship, including the right to control as to behavior, work, and pay. For work possibly beyond the employee’s scope of employment (such as work done after hours, at home, etc.), the questions become more difficult, and employers may have, at best, **shop rights** in the work. Shop rights permit employers to claim merely a nonexclusive license with limited rights to use the work, all without ultimate ownership rights. In such instances therefore, the employer would not be able to prevent the creator from selling or licensing the creation to others, even competitors. The Supreme Court decision, *Community for Creative Non-Violence v. Reid*,¹² is the controlling precedent on work for hire issues. The Copyright Office also provides guidance as to

⁸Report to Congress, *Taxation of Technical Services Personnel: Report on Section 1706 of the Tax Reform Act of 1986*, p. 5, Department of the Treasury, March 1991, <http://www.archive.org/details/taxationoftechni01unit>.

⁹The new reporting requirements are in § 6041 of the Internal Revenue Code, amended by § 9006 of the Patient Protection and Affordable Care Act of 2010, Pub. L. No. 111-148, 124 Stat. 119.

¹⁰IR-2010-79, July 1, 2010.

¹¹See 17 U.S.C. § 101 (2012), and Copyright Office Circular 9, *Works Made for Hire under the 1976 Copyright Act* (featured in Appendix 10).

¹²490 U.S. 730(1989).

works for hire, providing the following examples of when companies are the owners of the work:

- A software program created within the scope of his or her duties by a staff programmer for Creative Computer Corp.;
- A newspaper article written by a staff journalist for publication in the newspaper;
- A musical arrangement written for XYZ Music Co. by a salaried arranger on its staff;
- A sound recording created by the salaried staff engineers of ABC Record Co.

In cases where the work is performed by an independent contractor (such as when the ConnectU team asked a number of acquaintances, including Sanjay Mavinkurve, Victor Gao, and eventually, Mark Zuckerberg, for programming help on their early website concept), it may or may not be a work for hire. The question of ownership of the work is more complicated. The paradigm for analysis of whether it is a work for hire, and therefore owned by the hiring client company (rather than by the individual creator), three conditions must be met according to the copyright statute:

- The work must be specially ordered or commissioned (not yet in existence);
- The work must fall within one of the categories recognized by the Copyright Office, (Refer to Circular 9, in Appendix 10); and
- There must be an express agreement before the work begins specifying that this is a work for hire.

As a matter of protection, it is essential that companies require blanket copyright assignments to all works from employees, and most especially from all professional sub-contractors. An agreement with workers that a work is a work for hire is not enough; it is critical to execute an assignment as well in order to avoid the perils of negotiating for creative work to be completed only to find out later that the creator owns rights rather than the company. This next case highlights some of these difficulties.

STATE v. KIRBY

141 N.M. 838, 161 P.3d 883 (2007), 2009 N.M. App. LEXIS 213 (2009)

FACTS

Defendant Richard Kirby owned a small business, Global Exchange Holding, LLC, and for this venture, he hired Loren Collett, a sole proprietor operating under the name Starvation Graphics Company, to design and develop a website. They entered into a contract for website design services with Kirby agreeing to pay Collett \$1,890.00 for the work.

Collett did the work requested but was never paid. When Kirby changed the site password and locked Collett out from the site, Kirby was charged with one count of fraud, a fourth degree felony, using means of fraudulent conduct, practices, or representations. On appeal, Kirby challenges the sufficiency of the evidence that Collett was the actual owner of the site, an element required under the fraud statute. In effect, Kirby takes

the position that he, not Collett, owned the site, and therefore, he could not defraud himself. We granted certiorari to address the issue of who is the owner of a website under these circumstances: the designer or the person who hires the designer.

JUDICIAL OPINION

Judge Bosson: We first turn our attention to the legal document between Collett and Defendant, the “Website Design Contract.” According to that contract, Collett was engaged “for the specific project of developing and/or improving a World Wide Website to be installed on the client’s web space on a web-hosting service’s computer.” Thus, the end product of Collett’s work was the website, and the client, Defendant,

(Continued)

owned the web space. Defendant was to “select a web hosting service” which would allow Collett access to the website. Collett was to develop the website from content supplied by Defendant.

While the contract did not explicitly state who owned the website, it did specify ownership of the copyright to the web pages. “Copyright to the finished assembled work of web pages” was owned by Collett, and upon final payment Defendants would be “assigned rights to use as a website the design, graphics, and text contained in the finished assembled website.” Collett reserved the right to remove web pages from the internet until final payment was made. Thus, the contract makes clear that Collett was, and would remain, the owner of the copyright to the web pages making up the website. Upon payment, Defendant would receive a kind of license to use the website.

There are two exceptions to the general rule that the author of the work is the sole copyright owner. First, the creator of the work may not be the copyright owner in a “work made for hire” arrangement. [This includes] works prepared by an employee within the scope of his or her employment. The second work for hire exception applies to the independent contractor scenario, as exists here. To apply in the independent contractor context, the parties must expressly agree in a signed written instrument that the work will be work for hire and the work must be commissioned for one of the ... uses specified in the Copyright Act. Because these elements are lacking in this case, the work

made for hire exceptions do not apply [and therefore Collett remains the owner].

Defendant argues that because he owned certain elements that are part of a website and make it functional, he was the owner regardless of who owned copyright to the web pages. Specifically, Defendant purchased a domain name for the site, and contracted with a web hosting service, and owned the password that enabled him to control access to the site. While these elements are all necessary components of a website, none of these rises to the importance of the web pages that provide content. It is the information ... that creates substance and value. Ownership of the site follows from ownership of the copyright, unless otherwise agreed. Based on the evidence, a rational jury could have concluded that under the Website Design Contract, Collett owned the site, and ... Defendant committed fraud by taking property that belonged to another.

Conclusion:

We affirm the Court of Appeals.

IT IS SO ORDERED.

CASE QUESTIONS

1. How could businesses manage the employment relationship so as to avoid this risk?
2. How do you recommend the parties to proceed after this ruling?
3. How might Collett further establish rights to the website design?

Temporary Workers Temporary workers are contingent workers who typically have specialty credentials and are not employed by the company, but rather by the staffing agency. This is an ideal way to quickly secure much-needed talent when scaling up. Likewise, this is an ideal strategy for staffing work that is cyclical in nature. Agencies screen, employ, and handle payroll and taxes for temp workers, who take direction from and report to the client company. Temps are not eligible for client company benefits, though possibly eligible for some perks. Client companies are able to take on more risk with such staffing flexibility and shed staff as market conditions merit, ideal for uncertain business environments.

The status of temp workers as employees of the agency will be scrutinized by the Internal Revenue Service if there is evidence that the same temps work for many months at the same client employer's company. In *Vizcaino v. Microsoft*,¹³ the IRS successfully challenged the company's characterization of these workers as temps, and asked that these “permatemps” be reclassified as employees of Microsoft. The Ninth Circuit agreed, resulting in a \$97 million settlement of payments to workers, penalties, and back employment taxes. Microsoft and others subsequently reevaluated their business practices, creating new guidelines and hiring practices for temp workers.

¹³290 F.3d 1043 (9th Cir.), cert. denied sub nom., *Vizcaino v. Waite*, 2002 U.S. LEXIS 8338 (Nov. 11, 2002).

Unpaid Internship Workers Another classification of worker common to start-ups, and well known to students, is unpaid internships. Dubbed “full-time nonemployees” by Laurie Pike of *Entrepreneur.com*, this practice, too, has come under scrutiny of regulators. While nonprofits and government employers may agree with workers for a long-term full-time unpaid internship placement, private employers do not enjoy this same benefit. While such employment arrangements can be mutually advantageous to companies with lean budgets and workers with little experience, there are potential negatives in relation to exploiting workers and relying on this labor to sustain a business model over the long term. Sacrificing pay for experience has become an extremely common, almost well-settled route to professional salaried jobs, so much so that the Department of Labor addressed this practice in April 2010.

The federal Department of Labor’s Wage and Hour Division issued Fact Sheet 71, *Internship Programs Under The Fair Labor Standards Act* (which is featured in Appendix 11) listing six criteria for determining “whether interns must be paid the minimum wage and overtime ... for the services that they provide to ‘for-profit’ private sector employers” in that to qualify as an internship (rather than as unpaid work for which wages are owed) employers must demonstrate that the internship:

- includes training;
- benefits the intern;
- does not displace regular employees and is closely supervised by existing staff;
- the employer does not derive immediate advantage from intern’s contributions and employer operations may actually be impeded;
- the intern is not entitled to a job after the internship ends; and
- both parties understand the intern is not entitled to wages.

The question of what will trigger a wage and hour claim is difficult to predict, and businesses are often left wondering what work they may ask interns to do on occasion, such as coffee and lunch runs, but it is clear that there must be a formalized structure to the unpaid internship experience. The Department of Labor admits that the benefits are both mutual and enormous even as the agency attempts to police abuses and regulate on a case-by-case basis.

Foreign Workers Working in the U.S. With regard to immigration, recall that U.S. start-ups Pfizer, Sun, Intel, Yahoo!, DuPont, eBay, Proctor and Gamble, and Google were all begun by foreign-born founders. So were Nvidia, Akamai, PayPal, Hotmail, Red Hat, Computer Associates, and Flickr. “Foreign-born residents made up just 12.5 percent of the U.S. population in 2008 but nearly 40 percent of technology company founders and 52 percent of founders of companies in Silicon Valley.”¹⁴ This employment issue is clearly a top-tier concern for the Internet and tech sectors.

The U.S. immigration system features a series of visa preference categories based on certain criteria. Permanent worker visa preference categories are known as the EB series (**EB-1–EB-5**). The EB-3 is popularly called the *Green Card*; these visas are reserved for certain workers, including those with “extraordinary ability,” and ten years’ experience, or those who are investors with at least \$1 million of capital to invest in the United States. Recent college graduates do not qualify for these visas for the obvious reasons.

H1-B Visas **H1-B visas** are temporary work permits allocated to high-skill workers in specialty occupations. This is the main preference category used by the tech industry. This program was begun in recognition of the growing importance of technology to our economy, and in 1990 Congress approved a temporary (nonimmigrant track) work visa

¹⁴Paul Kedrosky and Brad Feld, “Start-up Visas Can Jump-Start the Economy,” Op-Ed, *Wall Street Journal*, December 2, 2009.

program for skilled workers sponsored by companies, making available 65,000 H1-B visas annually designated for nonimmigrant aliens who are highly skilled workers. Due to demand, the government holds a lottery for these visas. Notably, H1-B visa holders have no job mobility because their status is dependent on the sponsoring employer.

To more fully understand this phenomenon, in which innovation and employment goals in the U.S. economy conflict to some degree with U.S. immigration policy, consider an account of Sanjay Mavinkurve, mentioned previously for his brief stint writing code for the ConnectU team. Born in India to parents in a working-class family, he arrived in the U.S. via Saudi Arabia to attend a private high school on scholarship. He was eligible to reside here on an F-1 student visa. After graduation, he enrolled at Harvard, also on scholarship working on campus while excelling academically. After being awarded bachelor's and master's degrees in Computer Science, he was recruited by Google. Google secured a temporary worker H1-B visa for Mavinkurve, valid for up to six years, or more if applicants file for a permanent resident visa.

When applicants start this filing process, they are not allowed to change employers, or even get a different job within the same company because there is a high risk that the application process will then need to be restarted. The process is quite involved, starting with an ETA Form 9089 Application for Permanent Employment Certification; then if this is granted, on to a Form I-140 Immigrant Petition for Alien Worker. If this is successful, then applicants file a Form I-485 Application to Register Permanent Residence or Adjust Status.

This is when the process becomes even more opaque. No more than 7 percent of visas are allocated to immigrants from any one country. This means that immigrants from China are competing with one another for the same number of U.S. visas that immigrants from less populous countries (recall Mavinkurve was born in India, and therefore would be competing with an enormous population set for a visa). There are over 500,000 workers waiting for permanent legal residence through these preferred visa categories, which means that the wait time is very uncertain.

Meanwhile, spouses may not work, nor may they secure a Social Security card or driver's license, and with this level of insecurity, the visa program is not an attractive process for top tech candidates. In fact, due to the many opportunities that have opened in formerly closed nations, a number of foreign-born entrepreneurs are repatriating to their countries of origin rather than attempting to navigate the difficulties of the U.S. immigration system.

In the *Mavinkurve* case, after marrying he moved to Canada, which has no such immigration restrictions, to live with his wife and family; he still works for Google as the sole engineer in its Toronto office, which is otherwise staffed with sales and marketing personnel. He flies into Mountain View periodically for meetings, but otherwise communicates by email, instant messaging, or video conferencing. Approximately 10 percent of Google's workers are foreign-born holders of temporary visas. The company spends an estimated \$20 million per year on immigration issues, compliance, and administration.¹⁵ This is a system fraught with pitfalls. Employers may be reluctant to recruit and train highly talented foreign students who are graduating in record numbers from U.S. universities with highly developed skill sets to the extent a more welcoming immigration policy is not developed.

Foreign Workers of Off-Shore Businesses, Supply Chain Manufacturers That Partner with U.S. Businesses

A final notable issue occurring with greater frequency is the changing structure of the workplace itself. Our economic system is characterized by a market economy with low regulatory oversight and intense competitive pressures. The capital markets have become highly efficient, making possible a global economy, and with more countries' markets opened, the Internet has brought even more efficiencies

¹⁵For further research in this area, see Vivek Wadhwa et al., *America's New Immigrant Entrepreneurs: Part I*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=990152; Matt Richtel, "Tech Recruiting Clashes with Immigration Rules," *New York Times*, April 12, 2009.

to global business. Companies, under intense pressure to become more productive and lower costs in ways that the market recognizes as comparative advantages, are leveraging these capabilities through outsourcing. And as the work itself is in digital format and mostly intangible and service oriented (for such work as software programming, drafting legal documents, reading medical diagnostic results, and so forth) in contrast to manufacturing jobs for physical goods, the work is more able to be disaggregated.

Companies accomplish this by entering into complex supply chain manufacturing agreements and joint ventures with foreign partners.

Outsourcing is a form of labor arbitrage and involves the process of transferring work to a third-party subcontractor. It is a signature feature of capitalism with its emphasis on division of labor and productivity to optimize shareholder wealth. Outsourcing intensified with the introduction of modern telecommunications networks, the digitization of content, and broadband Internet connections, all of which create an optimal platform to engage in business transactions with different contract partners.

Offshoring is a subset of outsourcing and describes the process of locating some function or division of a business in a different country. As an example, consider IBM. Its employment peaked in 1985 when it employed over 400,000 workers. By 1992 it suffered losses in the billions, in part because it failed to transform its product lines from mainframes and typewriters to desktop computers. By 1994, its workforce shrunk to about 200,000 employees. IBM focused on what it thought was a core strength: business consulting. Its employee numbers grew during this period, with at least half working as IT professionals. In 2009, IBM announced that it would lay off thousands of its U.S. employees and that many of these employees had been offered jobs in India, Nigeria, Russia, Argentina, Brazil, China, Czech Republic, Hungary, Mexico, Poland, Romania, Slovakia, Slovenia, South Africa, Turkey, or the United Arab Emirates. IBM workers who choose to relocate will have their salaries reassessed too and will work on a different wage scale based on local wages and cost of living.

Working with foreign contract partners is a further variation in which entire operations are outsourced to separate companies; workers (typically off-shore in another country) are not officially employed by U.S. companies, and there is no direct responsibility to comply with U.S. regulation. Moreover, the regulatory environment in the contract partner's country is typically permissive, or lacking in enforcement, or perhaps even nonexistent. Important policy questions are being raised, including: where does responsibility start and end for these workers? For the environmental impacts? This is especially relevant as the technology more often than not was manufactured by Hon Hai Precision Industries (under the Foxconn brand), contract manufacturer for Apple, H-P, and many other companies. Hon Hai was the subject of tragic reports in which during just the first half of 2010, ten workers leaped off company roofs—all apparently suicides. The tech manufacturing industry is plagued with similar reports, including a Microsoft supplier said to force teens to work in unbearable conditions. Reports of dire working conditions would appear to not comply with Apple's and other companies' Codes of Conduct governing third-party manufacturers. Beyond these costs, experts criticize this contract manufacturing process, generally claiming it represents a crucial setback to the innovation ecosystem—in that all parts and workers engaged in the product or service chain should have the opportunity to personally interact, because in a disaggregated supply chain each producer is too narrowly focused on just one aspect of the whole.

The Term of Employment

The daily employment relationship is governed by an Employee Handbook or Policy and Procedures Manual. This is the most critical basis for establishing the employment relationship with employees, and creates a binding contractual agreement as to the terms and conditions of employment. Handbooks will cover major policies and expectations.

It will be updated periodically with notice given to employees as to changes in the terms and conditions of the employment relationship. Handbooks typically cover the following: performance reviews, raises and bonuses, work hours, payroll reporting, holidays, equal employment statement, harassment policy, appropriate uses of company property (including communications systems), data privacy and security, sensitive business information policy, phone reimbursement, client confidentiality, dress code, substance abuse and smoking, accident rules, insurance, health, disability, maternity, family and medical leave, funeral, jury, and tuition assistance.

Once the employment term begins, there may even be a probationary period during which time employees can be let go with no right of recourse. Employees in the U.S. generally are at-will. In an important distinction with the EU nations, the U.S. follows more closely a free-market system for labor that is regulated minimally, for wages, hours, health, and safety. Relatively few constraints are placed on employers. In the EU, countries embrace a social charter and more centralized government planning, with employment and wages guaranteed to workers, who are considered social and economic partners with their companies. In the U.S., it is easy to hire and fire based on need and market conditions; not so in the EU. Employees may not be fired. One of the important collateral effects of these differences is that there is more risk taking in the U.S., leading to more leverage, more churn, and more dislocation.

Employees are governed by principal-agency law whereby each party has rights and owes duties to the other party. **Fiduciary duties** are implied in the employment relationship. Employers as principals hire employees, the agents, to operate under their control and on their behalf. Employers are obligated to disclose all relevant information to employees so that they can perform their tasks and are also obligated to pay a reasonable wage for all services. Employers are legally bound by the actions of employees operating within the parameters of the employment relationship. Employers owe fiduciary duties to employees; this is most often litigated in the context of benefits and retirement plans. Employees are obligated to act on behalf of the employer. Fiduciary duties are implied for agents: the **duty of loyalty** (the duty to act solely on behalf of the employer, free from conflicts of interest such as self-dealing as would be the case in secret commissions) and the **duty of care** (the duty to act reasonably on the employer's behalf, in accordance with industry standards, free from negligence or recklessness). With employees less tethered to the physical office, it is in some ways less possible for employers to have a clear sense of employees' interactions and results.

Employee communications are an area of intense scrutiny, and as to private employers, employees should have no expectation of privacy in employer communications systems. There is an urgent need for direction in this practice area, and employers must set forth a clear policy in the Handbook as to expectations, along with examples of acceptable and unacceptable employee use of communications systems, along with yearly reminders. Furthermore, to the extent employees are using their own equipment, employers must still develop a policy as to what uses are acceptable during work time and how much time is allowed for these uses, along with clear examples. Many employers use technology to control and monitor workplace communications for fear of liability and loss of sensitive business information, and an array of technologies including filtering, blocking, keystroke logging, and monitoring is a reality of company networks.

During the term of employment, special challenges arise with regard to communications technologies. The modes of communications seemingly multiply each year, and with corporate assets increasingly digital and accessible to large numbers of employees, it is quite difficult to manage corporate matters in a networked environment, with employees blogging about work, chatting about their company on financial forums, and downloading or emailing work documents to home computers and so forth. This necessitates a systemic approach to corporate communications, ranging from data and network security practices, to

tiered access to information, as well as pervasive filtering and monitoring technologies in the workplace. It is further advisable to monitor company buzz on the Internet and ensure that none of it contains confidential or sensitive business information. It is critical for employers to develop communications policies to the extent that the issues are not addressed in employment agreements. For example, a Cisco executive in charge of directing the company's Intellectual Property department wrote a pseudonymous blog hosted by Blogspot. His posts focused on patent litigation, and when he revealed his identity, a number of problems arose to be sure. Cisco's blogging policy now provides, "If you comment on any aspect of the company business or any policy issue the company is involved in where you have responsibility for Cisco's engagement, you must clearly identify yourself as a Cisco employee ... and include a disclaimer that the views are your own and not those of Cisco."

The Postemployment Term

Employers have a great deal of latitude in making employment decisions for at-will employees. The legal reasons to terminate employees are due to: violations of known and enforced company rules, poor job performance of those tasks the employee was charged with accomplishing, or adverse economic conditions. To avoid risk of retaliation, employers are advised to document the reasons and the process, and then finish with an exit interview. Employees laid off are eligible for unemployment benefits. Sometimes employees leave by choice. In any event, departures may start the enforcement period of a post-separation agreement, such as a severance or a forfeiture agreement.

Some parts of the employment agreement terminate at this time (for example, restricted shares in an employee stock option agreement), while other parts of the employment agreement may survive (for example, NDAs, NCAs, and so forth). Employees in such instances remain bound to these agreements, even when they start a new job with a different employer. It is imperative for employers to review all relevant agreements at this time. Finally, it is critical to ensure that the IT division is made aware of departing employees because continued access to employer resources, especially computer and network systems, can have horrendous consequences.

This employment case shows the amazing effects of the Internet—now individuals have the same communications potential as large corporate or government entities. This case also highlights the tensions between employers' property rights and individuals' expressive rights.

INTEL v. HAMIDI

30 Cal. 4th 1342 (2003) (4–3 decision)

FACTS

Kourosch Kenneth Hamidi, a former Intel engineer, formed an organization named FACE-Intel (Former and Current Employees of Intel). Its purpose is to disseminate information and views critical of Intel's employment and personnel policies and practices. FACE-Intel maintained a website, and through it, Hamidi sent six emails to Intel employees (as many as 35,000), criticizing Intel's employment practices.

Intel attempted to block internal transmission of the messages, but only partly succeeded. (Hamidi evaded blocking efforts by using different sending computers.)

Intel demanded that Hamidi stop sending emails; but Hamidi asserted the organization had a right to communicate with willing Intel employees. He offered to, and did remove from his mailing list any recipient who so wished. Hamidi breached no computer security barriers in order to send the emails. Hamidi's communications to Intel employees caused neither physical damage nor functional disruption, nor did they deprive Intel use of its computers. The contents of the messages, however, caused discussion among Intel employees and managers.

(Continued)

Intel filed suit against Hamidi based on the theories of trespass and nuisance. Intel sought damages as well as an injunction against further email messages.

JUDICIAL OPINION

JUDGE WERDEGAR

To be actionable, the defendant's interference must have caused some injury to the chattel [thing], or to the plaintiff's right in it. Under California law, trespass to chattels lies where an intentional interference with the possession of personal property *has proximately caused injury*. The [law] makes clear that some actual injury must have occurred in order for a trespass to chattels to be actionable. [For example] dispossession alone ... is actionable [which was not the case here], but other lesser forms of interference require some additional harm to the personal property, or to the possessor's interest in it.

The dispositive issue in this case, therefore, is whether the ... facts demonstrate Hamidi's actions caused or threatened to cause damage to Intel's computer system, or injury to its rights in that personal property, such as to entitle Intel to judgment. Intel contends that, while its computers were not damaged by receiving Hamidi's messages, its interest in the physical condition, quality or value of the computers was harmed. We disagree. Rather, the decisions [that have found] trespass to computer systems have generally involved some actual or threatened interference with the computers' functioning. [The Court notes that Intel does not claim the type of impact that spammers and robots have been alleged to cause.] Though Hamidi sent thousands of copies of the same message, that number is miniscule compared to the amounts of mail sent by commercial operations.

[Furthermore] Intel alleges that its workers were distracted from their work ... because of assertions and opinions the messages conveyed. Intel's complaint in this respect is thus about *the contents of the messages* rather than the functioning of the company's email system. This theory of "impairment by content" threatens to stretch trespass law to cover injuries far afield from the harms to possession the tort theory evolved to protect. Whatever interest Intel may have in preventing its employees from receiving disruptive communications, it is not an interest in personal property, and trespass to chattels is therefore not an action that will lie to protect it.

Intel connected its email system to the internet and permitted its employees to make use of this connection both for business and, to a reasonable extent, for their own purposes. In doing so, the company necessarily

contemplated the employees' receipt of unsolicited as well as solicited communications from other companies and individuals. That some communications would, because of their contents, be unwelcome to Intel management was virtually inevitable. Hamidi did nothing but use the email system for its intended purpose—to communicate with employees. We conclude, therefore, that Intel has not presented undisputed facts demonstrating an injury to its personal property, or to its legal interest in that property, that support, under California tort law, an action for trespass to chattels. No such injury having been shown on the undisputed facts, Intel was not entitled to summary judgment in its favor. The judgment of the Court of Appeal is reversed.

DISSENT

JUDGE BROWN

Intel Corp. has invested millions of dollars to develop and maintain a computer system. It did this not to act as a public forum, but to enhance the productivity of its employees. Intel had the right to exclude the unwanted speaker from its property. Hamidi sent as many as 200,000 email messages to Intel employees. The time required to review and delete Hamidi's messages diverted employees from productive tasks and undermined the utility of the system. The majority misses the point that Intel's objection is directed not toward Hamidi's message but his use of Intel's property to display his message. Intel has not sought to prevent Hamidi from expressing his ideas on his web site ... or through paper or electronic mail to employees' homes, or through other means like picketing or billboards. But as counsel for Intel explained ... the company objects to Hamidi's using Intel's property to advance his message. Because I do not share the majority's antipathy toward property rights and believe the proper balance between expressive activity and property protection can be achieved without distorting the law of trespass, I respectfully dissent.

CASE QUESTIONS

1. Who do you think "got it right": the majority, or the dissent—and why?
2. Intel tried theories of trespass and nuisance, both inapposite according to the majority. What are your recommendations for Intel at this time?
3. Identify business strategies and technical ways to address this problem, in contrast to the legal strategy used in this litigation.

Employment Agreements

Employment agreements, as with all contracts, represent an effort by both parties to formalize their understanding of the employment relationship. This is especially vital for the Internet and tech sectors in which assets are more defined by brilliant restless employees and their coding creations than by legacy (and stationary) assets like property, plant, and equipment. Employment agreements are an essential element for all parties in such circumstances. They also serve to provide guidelines as to each party's rights and responsibilities and represent an attempt to structure a relationship that best aligns the interests: employer goals to maximize shareholder wealth, with employee incentives and rewards, all while achieving performance and satisfaction. Employment agreements typically are negotiated before the employment term commences. Employers will also negotiate agreements with temporary hires, part-time hires, and consultants or other company-affiliated workers. Formerly, workers went to their place of work, where the tools of work were, and this was the only place work could be done. Now however, as with all things digital and networked, workers do not necessarily have to go to a place of work to get their work done. In many Internet and technology jobs, the tools of work are relatively inexpensive and ubiquitous: with a smartphone and Internet connectivity, employees are able to work from anywhere to create software programs, grant loans, fix banking mistakes, write and submit news stories, and so forth. Computers and phones have become the machinery of the Information Age. In tandem with their offsite computing capabilities, employees have virtual offices anywhere, and their individual value to companies is commensurately high.

This paradigm shift from the primacy of the workplace and physical manufacturing as the wealth creator, to the individual as the wealth creator is especially evident in the Internet and tech sectors, and it necessitates a more nuanced approach to managing employment relationships. Employee access to the company assets (such as the company's intellectual property, which they probably helped develop) means that a departing employee (and in this sector where job mobility is high) is now a potentially devastating incident for companies. One of the very reasons prospective employees might be considered an important hire is the fact that they have developed an expertise and a coveted skill set. It is likely that these prospective employees are themselves bound to employment agreements, and therefore hiring them away is currently the source of a tremendous amount of litigation. The theme that runs through this employment material highlights a balancing act: balancing employers' investment in their company and assets, with employees' skills they developed at that company even as they have a right to job mobility, all played out against the backdrop of radically changed capital, output, and labor markets.

This section summarizes the various employment agreements negotiated with incoming employees. In general, employees' accumulated knowledge and experience, as well as skills acquired on the job are portable, but sometimes questions arise regarding to what extent incoming employees bring with them data and information that the previous employer claims as proprietary, and thus wrongfully taken by the departing employee. Knowledge spillover, as this is known, is a serious concern for employers. Sometimes spillover is voluntary, such as when companies intentionally pursue joint ventures and so forth, with parties' respective rights and obligations clearly defined in the agreement. Spillover is also caused involuntarily with employee job changes. Employment agreements seek to contain risks associated with job mobility. In addition to the substantive terms of the employment agreements, there are additional procedural terms common to all contracts, including: venue, choice of law, arbitration rules, and so forth.

Invention Assignment Agreements (IAAs)

Invention assignment agreements (IAAs) are meant to capture and assign to the company all inventions of the employee. The employee agrees to surrender all ownership rights in the invention and assign them to the company (the assignee). The assignment covers all associated data, formulae, know-how, and trade secrets that form the basis for the invention. It is critical to note that an assignment of inventions agreement is different from a licensing arrangement (in which the inventor retains rights in and control to the technology, and grants the company limited rights to use the technology). Furthermore, employees are required to disclose all inventions to the company in a timely manner and maintain adequate records of the inventing process. Inventions included within the scope of this agreement survive even the term of employment. This occurs when, for example, an employee departs or is fired, but their ideas conceived during the term of employment belong to the company and not to the employee or their subsequent employer.

IAAs commonly cover all work pursued during the term of employment that relates to the company's current or anticipated areas of business research or development, while using the company's property (including physical and intellectual property), equipment, supplies—in essence any company resource. It is a challenge in this area to balance the rights of employers and employees. (Recall the *Iconix* case in Chapter 2.) IAAs, and all agreements, are governed by state law, and therefore parties should expect that there will be wide differences among jurisdictions on these agreements. Notably, California Labor Code Section 2870 provides that IAAs do not apply “to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information....”

The following case is a striking example of a high-stakes competitive environment with departing employees, ideas, copyrights, trademarks, and an invention assignment agreement that may, or may not, be applicable.

MATTEL, INC. v. MGA ENTERTAINMENT, INC. 2009 U.S. App. LEXIS 29187 (9th Cir. July 22, 2010)

FACTS

Mattel employee Carter Bryant worked in the “Barbie Collectibles” department where he designed fashion and hairstyles for the dolls. In August 2000, while still employed by Mattel, Bryant pitched his idea for the Bratz line of dolls to MGA, one of Mattel's competitors. Bryant received a callback from MGA's CEO, and for that meeting Bryant brought preliminary sketches as well as a crude dummy constructed out of a doll head from a Mattel bin, a Barbie body, and Ken boots. Bryant signed a consulting agreement with MGA dated Sept. 18, 2000. He gave Mattel two weeks' notice on October 4th, and continued working there until October 19th. During this period he was also working with MGA to develop Bratz, even creating a preliminary sculpt (a mannequin-like plastic doll body without skin coloring, face paint, hair or clothing. The sculpt

was actually created by a freelancer working for Bryant and Bryant owns all rights to it).

MGA kept Bryant's involvement with the Bratz project secret, but Mattel eventually found out. This led to a number of lawsuits. Proceedings were split into two phases: Phase 1 dealt with the claims relating to the ownership of Bratz; Phase 2 is pending and will deal with the remaining claims. This is an appeal from the equitable orders entered at the conclusion of Phase 1. During Phase 1, Mattel argued that Bryant violated his employment agreement by going to MGA with his Bratz idea instead of disclosing and assigning it to Mattel. Mattel claimed it was the rightful owner of the sketches and sculpt, and therefore the subsequent Bratz dolls infringed. Mattel won virtually every point below. The jury awarded Mattel \$10 million along with equitable relief that imposed a constructive trust over

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all trademarks and copyrights, and prohibited MGA from marketing any Bratz-branded products.

JUDICIAL OPINION

CHIEF JUDGE KOZINSKI

I. Who owns Bratz?

Barbie was the unrivaled queen of the fashion-doll market throughout the latter half of the 20th Century. But 2001 saw the introduction of Bratz, “The Girls With a Passion for Fashion!” This spunk struck a chord, and Bratz became an overnight success. Mattel, which produces Barbie, didn’t relish the competition. And it was particularly unhappy when it learned that the man behind Bratz was its own former employee, Carter Bryant.

II. A constructive trust would be appropriate only if Bryant assigned his ideas for Bratz to Mattel in the first place. Whether he did turns on the interpretation of Bryant’s 1999 employment agreement, which provides: “I agree to communicate to the Company ... all inventions conceived or reduced to practice by me ... at any time during my employment by the Company. I hereby assign to the Company ... all my right, title and interest in such inventions, and all my right, title and interest in any patents, copyrights, patent applications or copyright applications based thereon.”

The contract specifies that the term “invention” includes, but is not limited to all discoveries, improvements, processes, developments, designs, know-how, data computer programs and formulae. The district court held that the agreement assigned Bryant’s ideas to Mattel, even though ideas are not specifically listed in the contract. We review the district court’s construction of the agreement *de novo*.

Mattel points out that the list of examples of what constitutes an invention is illustrative rather than exclusive. Ideas, however, are markedly different from most of the listed examples. Designs, processes, computer programs, etc. are concrete, unlike ideas, which are ephemeral and often reflect bursts of inspiration that exist only in the mind. On the other hand, the agreement also lists less tangible invention such know-how and discoveries. We conclude that the agreement could be interpreted to cover ideas, but the text doesn’t compel that reading. [Plus] during litigation, the parties introduced other contracts, one for example Mattel drafted for employees in which they expressly assigned their ideas as well as their inventions which tends to show that the term inventions alone doesn’t include ideas. The district court thus erred in holding that the agreement ... clearly covered ideas.

III. Mattel also claimed ownership of Bryant’s preliminary Bratz drawings and sculpt under Bryant’s employment agreement, and that MGA dolls infringed its copyrights in those works. The drawings and sculpt clearly were inventions as that term is defined in Bryant’s employment agreement with Mattel. However, MGA argued that the employment agreement didn’t assign the items because Bryant created them outside the scope of his employment at Mattel, on his own time. The district court held that the agreement assigned inventions even if they were not made during working hours, so long as they were created during the time period Bryant was employed by Mattel. The jury was not asked to find whether Bryant made the drawings and sculpt during Mattel work hours, and it’s unclear whether the record contained any evidence on this point.

The phrase “at any time during my employment” is ambiguous. It could easily refer to the entire calendar period he worked for Mattel, including nights and weekends. But it can also be read more narrowly to encompass only those inventions created during work hours, possibly including lunch and coffee breaks. Extrinsic evidence doesn’t resolve the ambiguity. For example, an employee testified that it was “common knowledge that a lot of people were moonlighting and doing other work,” which wasn’t a problem so long as it was done on their own time. However, another employee testified, “Everything I did for Mattel belonged to Mattel. Actually, everything I did while I was working for Mattel belonged to Mattel.” The issue should have been submitted to the jury, which could then have been instructed to determine (1) whether Bryant’s agreement assigned works created outside the scope of his employment at Mattel, and (2) whether Bryant’s creation of the Bratz sketches and sculpt was outside the scope of his employment...

* * *

Bryant’s employment agreement may not have assigned his ideas for the Bratz name to Mattel at all, and the district court erred by holding that it did so unambiguously. Even if Bryant did assign his ideas, the district court abused its discretion in transferring the entire Bratz trademark portfolio to Mattel. We therefore vacate the constructive trust and injunction. The district court may impose a narrower constructive trust on remand only if there’s a proper determination that Mattel owns Bryant’s ideas.

The district court also erred in holding, at summary judgment, that the employment agreement assigned

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works created outside the scope of Bryant's employment. We therefore vacate the copyright injunction. On remand, Mattel will have to convince a jury that the agreement assigned Bryant's preliminary sketches and sculpt, either because the agreement assigns works made outside the scope of employment or because these works weren't made outside of Bryant's employment.

America thrives on competition; Barbie, the all-American girl, will too. Equitable relief vacated. Each party shall bear its own costs.

CASE QUESTIONS

1. After this case, identify the most important changes Mattel should make to its employee agreements.
2. After this case, identify how the state law could be amended in order to add clarity to the definition of what is work time.
3. **Ethical Consideration:** As a matter of policy, if there is a question between equally meritorious competing claims of employees and employers because the agreement is unclear and thus susceptible to either interpretation, who should prevail?

Nondisclosure Agreements (NDAs)

Nondisclosure agreements (NDAs) are meant to ensure that the company retains control over dissemination of any proprietary or sensitive business information that employees use, learn about, or even helped develop during the employment term. Previously set forth in Chapter 7, mention is further made here because such agreements are integral to employment relationships, especially with employees in creative and tech sectors. NDAs create a contractual relationship between the parties in an effort to protect against the risk of disclosure of trade secrets or other confidential information. NDAs cover two main points. First, they create a confidential relationship between the parties and outline the scope of materials and information covered, essentially nonpublic business information. The breadth of this covered information is broader than for trade secrets and specifies that the information is confidential. Second, the agreement covers the length of the agreement starting at the term of employment and even remains in effect for a defined period following the term of employment.

The scope of NDAs is subject to agreement. Employers favor broadly worded agreements, while employees favor agreements that are specific and limited in their terms and term length. Again, there is tension between employers' need for secrecy of strategic business information in order to maintain a competitive advantage, and employees who may wish to change jobs for what they perceive as better opportunities. Generally, an employee upon termination may carry away and use the general skills, technical know-how, or knowledge acquired during the course of employment. This promotes the public interest in employment and freedom to practice one's profession, as well as in mitigating monopoly tendencies of employers.

Some jurisdictions construe NDAs quite broadly and will grant injunctions against departing employees when there is a risk of "inevitable disclosure" of trade secret or other sensitive business information. The most widely acknowledged precedent for this doctrine is *PepsiCo., Inc. v. Redmond*,¹⁶ in which the court granted an injunction enjoining a departing employee's disclosure of trade secrets or even work in beverage pricing, sales, marketing, and distribution. This ruling was based on inference, without proof of the employee's actual or threatened use of this information. This doctrine has been repudiated in California, but is still followed in a number of other jurisdictions.

States clearly favor the enforceability of NDAs, provided that the scope of covered information is written into the agreement and that it is reasonable, based upon the

¹⁶54 F.3d 1262 (7th Cir. 1995).

employees' job status and work duties. Limits to the validity of NDAs can be found when the information alleged to be covered is otherwise publicly available or when the employee had access to the information prior to the term of employment.

As an example of the difficulties involved in these cases and to gain insight on how closely NDAs and **noncompete agreements** (which follow below) are related, recall the *Papermaster* case from Chapter 7. IBM executive Mark Papermaster was part of an IBM unit charged with helping customers integrate technology into their businesses, when Apple hired Papermaster away to run its iPhone division. Papermaster had previously signed employment agreements with IBM on these points, but claimed they were inapplicable since the two businesses are entirely distinct. The court first considered whether Apple and IBM were competitors, and second, whether Papermaster's work at IBM gave him knowledge that will ultimately give Apple an unfair competitive advantage that harms IBM's interests. In his order, Judge Karas wrote, "The harm to IBM ... is more likely to derive from inadvertent disclosure of the IBM trade secrets that have defined Mr. Papermaster's long career. Put another way, what other base of technical know-how could Mr. Papermaster draw upon to perform his new and important job? Thus, while the court ascribes no ill will to Mr. Papermaster, the Court finds that the likely inevitability of even inadvertent disclosure is sufficient to establish a real risk of irreparable harm to IBM." The Court entered an order stipulating that Papermaster could start work at Apple but remained under an obligation not to use or disclose IBM's confidential information as defined in his agreements with IBM. For any further clarifications, Papermaster must contact IBM's Vice President and Assistant General Counsel on questions as to whether specific information meets the definition of confidential information.

Noncompete Agreements (NCAs)

Covenants not to compete with former employers are the most litigated of employment agreements. Employers rely on NCAs to prevent former employees from using all they have learned from using that as a competitive advantage.

NCAs cover three points:

- *Time*: Employees agree to refrain from working for competitors for a specified period of time;
- *Place*: Employees agree to refrain from working for competitors within a certain geographic area; and
- *Scope*: Employees agree to refrain from working for competitors whose business consists of similar work, or those whose business could expand into that field of work.

Employees have access to customer lists, strategic business plans, salary information, production and design materials, costs, and so forth. Employees who leave and start up a

EXHIBIT 10.2 Excerpt from the IBM-Papermaster NCA

NONCOMPETITION AGREEMENT "... You acknowledge and agree that: (i) the business in which IBM ... [is] engaged is intensely competitive ... that you have access to, and knowledge of, confidential information of the Company, including, but not limited to, certain or all of the Company's methods, information, systems, plans for acquisition or disposition of products, expansion plans, financial status and plans, customer lists, client data, personnel information and trade secrets of the Company, which are of vital importance to the success of the Company's business; (ii) the disclosure of any of the foregoing could place the Company at a serious competitive disadvantage and could do serious damage ...; (iii) you have been given access to, and developed relationships with, customers of the Company at the time and expense of the Company; and (iv) by your training, experience and expertise, your service to the Company are, and will continue to be, extraordinary, special and unique."

competing business start with a significant advantage based on that knowledge. Furthermore, they invariably have lower fixed costs and are better able to move into markets because the original business faces, among other impediments, the innovator's dilemma. Employees naturally disfavor NCAs because they prevent employment at certain companies, which not coincidentally are those with which employees have the most compatible skill set, and render it unduly burdensome for employees to earn a living.

Courts understand that employers have invested time and resources in their employees and these are protectable interests, but that employees have the right to earn a living and to job mobility in a free-market economy. For those jurisdictions that recognize NCAs, employers are favored at the expense of talented individual employees, tending to lead to static markets, less job mobility, less innovation, and lower salary structures. For those jurisdictions that do not recognize NCAs, talented individual employees are favored at the expense of employers, tending to lead to dynamic unpredictable markets, higher job mobility, more innovation, and higher salary structures. This also creates higher personnel and administrative costs for businesses. Historically such restrictions on employee mobility were presumptively invalid. But NCAs gained legitimacy as large organizational entities gained bargaining power over employees. This is a highly unsettled area of law presently, as states' laws differ with respect to the validity of NCAs. For example, NCAs are void in California, but valid in a number of other states, including Massachusetts and New York.¹⁷ Scholars have tracked the results of NCAs and innovation and concluded that there is a competitiveness gap between states that enforce NCAs and those that do not, with those in the latter category seeing higher productivity and reaping higher economic rewards from creativity unleashed: more start-ups, risk taking, and the spillover of know-how.¹⁸

Employers have the burden of identifying a protectable legitimate business interest that the NCA protects. In those jurisdictions that recognize NCAs, a rule of reason test is used when considering the validity of the terms.

Courts consider:

- whether the restraint is designed to protect some legitimate interest of the employer (or is it merely to restrain ordinary competition); and
- whether each of the restraints is reasonable as to time, place and scope.

It is possible, too, that even if there is a finding that the NCA is an unreasonable restraint under the rule of reason test, some jurisdictions had adopted the *blue pencil* rule¹⁹ and either strike, or more extremely, modify terms that violate an otherwise valid NCA. Because this rule works to completely frustrate employers' goals, employers are advised to manage this risk by including a "step-down provision" in their NCAs, permitting courts to reform (i.e., rewrite more reasonable restrictions) provisions as a substitute for any terms found to be unreasonable.

This next case represents an employment contract typical for tech stand-outs: it includes an NCA, signed when the term of employment began, and then later on this employee is lured away for new challenges with a fresh start and perspective at another company. The departing employee (with help from the new employer) challenges the validity of the NCA.

¹⁷See David P. Twomey and Marianne Moody Jennings, *Business Law*, p. 420 (3d ed. 2011).

¹⁸See Ronald J. Gibson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. Rev. 575 (1999). Further, legislators in Massachusetts are drafting a bill to eliminate restrictive employer covenants. For updates, see the Boston Bar Association's page, <http://www.bostonbar.org>.

¹⁹See Restatement (Second) of Contracts, § 184 (1981). Courts generally will not re-write contracts; rather they will strike unreasonable terms.

GOOGLE v. MICROSOFT

415 F. Supp. 2d 1018 (N.D. Cal. 2005)

FACTS

In 2000, Dr. Kai-Fu Lee began working as Microsoft's VP for Research and Development. Lee's employment agreement with Microsoft contains a limited covenant not to compete:

While employed at MICROSOFT and for a period of one year thereafter, I will not (a) accept employment or engage in activities competitive with products, services, or projects (including actual or demonstrably anticipated research or development) on which I worked or about which I learned confidential or proprietary information or trade secrets while employed at MICROSOFT: (b) render services in any capacity to any client or customer of MICROSOFT for which I performed services during the twelve months prior to leaving MICROSOFT's employ[ment]: (c) induce, attempt to induce, or assist another to ... terminate his employment with MICROSOFT or to work for me or for any other person or entity. If during or after my employment with MICROSOFT I seek work elsewhere, I will provide a copy of this Agreement to any persons or entities by whom I am seeking to be hired before accepting employment or engagement by them.

The agreement provides (1) that it shall be governed by the laws of the State of Washington and (2) that exclusive venue and exclusive personal jurisdiction for an action ... shall lie in state or federal court in Washington. Finally, the agreement contains a non-disclosure agreement in which Lee agreed "not [to] disclose to anyone outside MICROSOFT nor use for any purpose other than my work for MICROSOFT any MICROSOFT confidential or proprietary information or trade secrets.

In May 2005, Lee approached Google about leaving Microsoft and coming to work for Google. In July 2005 Lee quit his job at Microsoft, and accepted a job at Google, a California company, but the job title was VP of Engineering at the planned R&D facility in China. Later that day, Microsoft file a complaint against Google and Lee in Washington state court, alleging (1) breach of the agreement not to compete; and (2) breach of the non-disclosure promises and misappropriation of trade secrets, and (3) tortious interference with contractual relations.

Three days later, Google and Lee filed their own lawsuit in a California state court, seeking a declaration that the Microsoft agreement/contract not to compete based on Washington state law is invalid and

unenforceable under California law. Microsoft petitioned to remove Google's lawsuit from the California state court in favor of a federal district court in California [this opinion is the federal district court's decision].

Meanwhile, in the Washington state case, that court issued a Temporary Restraining Order [TRO] against Google and Lee, lasting 10 days until a full hearing could be held on the issues. During that subsequent hearing, the Washington state court issued a preliminary injunction prohibiting Lee from accepting employment with Google involving competitive activities—including but not limited to: computer search technologies, language or speech technologies, or participating in any set-up or budgeting discussion relating to the R&D facility in China.

The Declaratory Judgment Act provides that in a case of actual controversy within its jurisdiction, any court of the United States *may* declare the rights of any interested party. Federal courts therefore enjoy unique and substantial discretion in deciding whether to declare the rights of litigants. Microsoft urges this [federal court in California] to refuse jurisdiction in light of the pending Washington state proceeding. Other courts in this district have declined to issue declarations on the enforceability of covenants not to compete. [For example], in *DeFeo v. Procter & Gamble*, DeFeo worked for P&G in Ohio. His stock option plan included a covenant not to compete. When DeFeo quit his job and accepted a job with Clorox in California, P&G told DeFeo that it would sue him. DeFeo filed a suit in California state court seeking a declaration that the P&G covenant not to compete was unenforceable. One day later, P&G sought injunctive relief in Ohio state court. P&G removed the California case to federal court and the moved to dismiss it. The California court granted the motion to dismiss, reasoning that there was no need for two courts to address the same issue simultaneously, where the issue involves exclusively questions of state law.

Just as [in that case] the court declined to grant declaratory relief because doing so would reward forum shopping, this court elects to stay [stop] this action [in California] by Google and Lee, which they admit they filed to try to secure a California forum. The Washington state court has already held hearings on this case and set a trial date. However, Google and Lee correctly note that in *DeFeo* and the other cases there is a presumption resting upon the premise that

(Continued)

the same issues are pending in both courts. Google and Lee contend that this is not true here.

Google and Lee argue that the Washington state court will apply Washington law on all questions, and that that this distinction is crucial—because California and Washington view covenants not to compete differently. While California law considers covenants not to compete to be void, Washington upholds such covenants. Thus Google and Lee contend that the Washington state court forum ... is inadequate to protect their rights under California law.

The flaw in this argument is that Google and Lee fail to explain why they cannot ask the Washington state court to apply California law. Both states adhere to the [the same rules regarding conflicts of laws] in determining whether forum selection and choice-of-law clauses are valid. As these clauses were generated in arm's length transactions, they are to be construed as reasonable, and thus valid. Courts are permitted to strike down these clauses when application of the law of the chosen state [here—Washington law] would be contrary to the fundamental policy of a state which has a materially greater interest than the chosen state, and if that state would be the place where the contract is to be

performed. Therefore a Washington state court could apply California law, if California has a materially greater interest than Washington in the validity of the covenant not to compete, and California would be the place of performance of the contract. This [federal court in California] court hereby stays the case until completion of the Washington state proceedings.

[Note: a copy of the Judge's Temporary Restraining Order is featured in Appendix 13.]

CASE QUESTIONS

1. In this case, the parties eventually settled, and Dr. Lee went on to run the Google China initiative (which he has since left to become a venture capital investor). If you were running Microsoft, what would you have done differently in this situation?
2. Given that there are wide differences in outcomes in this area because contracts law is not federalized, are there any strategies you can identify for businesses to manage these risks?
3. Considering that this is a common scenario, how do you recommend companies to respond in the future?

Forfeiture Agreements

As a complementary, and perhaps more useful strategy than NCAs for managing key employee attrition, employers write forfeiture clauses into employment agreements. Forfeiture clauses target nonsalary compensation (such as bonuses, stock or stock options, and so forth) paid out during a specified period that will be forfeited upon an employee's departure to any company in the same industry. Courts generally will not uphold agreements that purport to claim forfeiture of salary compensation as this is considered too harsh a penalty. Forfeiture clauses are widely recognized as valid and therefore hold more promise for enforceability than do NCAs. This next case considers the applicability and validity of a forfeiture clause.

VIAD CORP. v. HOUGHTON

2010 U.S. Dist. LEXIS 17447 (E.D. Ill. Feb. 26, 2010)

FACTS

Plaintiff Viad Corp. is incorporated in Delaware and provides services to exhibition organizers and exhibitors for trade and industry shows. Defendant Anne Houghton, an Illinois resident, was hired by Plaintiff in 1997 as a senior designer. Houghton was promoted several times and eventually became Senior Vice President of Design and Creative. She supervised a team of employees had

budget responsibilities, and was involved in new client development. She worked primarily in "Exhibit Services," as opposed to working in "Exposition Management." She was privy to internal strategic planning and knew Plaintiff's costs for providing its services. Her base salary was \$175,000, and because of her senior position, she was eligible to participate in a voluntary Incentive Plan.

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The Plan's purpose was to provide key executives with incentives to achieve goals set forth in the Plan. Performance goals were tied to overall company performance and included targets for pre-tax income, value added measurement, cash flow, revenue and other performance measures. The Plan identified bonuses paid under this as "special compensation."

Paragraph V9A0 provided in pertinent part:

In order to better protect the goodwill of Viad ... and to prevent the disclosure of Viad's ... trade secrets and confidential information ... each participant in this Plan, without prior written consent of Viad, will not engage in any activity or provide any services ... for a period of two years following the date of such participant's termination of employment with Viad.

The Plan also required the repayment of payments made under the Plan in the following circumstances:

If at any time within two years following the date of a participant's termination of employment with Viad ... such participant engages in any conduct agreed to be avoided ... then all bonuses paid under this Plan to such participant during the last 12 months of employment shall be returned or otherwise repaid by such participant to Viad.

After reviewing the Plan, Houghton elected to participate in 2007. In March 2008, Houghton received a payout of \$102,000 under the 2007 Plan. Later on, in September 2008, Houghton resigned from Viad and began working for The Freeman Companies, a direct competitor in the exhibit and event design industry. Freeman's corporate structure was just like Viad's. Her work at Freeman was similar and the two companies sell similar design services. A number of clients left Viad and began using Freeman, the competitor. As of the date of resignation, Houghton forfeited previously awarded stock options, restricted stock and performance units under the terms of those plans (which are separate from the 2007 Plan payments at issue). Plaintiff demanded repayment of the \$102,000 payout made to Houghton under that Plan. Houghton refused to return the payout. Plaintiff filed a breach of contract suit alleging that Defendant breached a clause in the Management Incentive Plan that was a forfeiture clause. Both parties moved for summary judgment.

JUDICIAL OPINION

JUDGE DOW

Under the terms of the Plan, if Houghton went to work for a competitor and provided services to the

competitor that were "directly concerned" with the services that she performed during her last two years of employment or about which she had confidential information, she was required to return the payout. The parties do not dispute that the two companies compete. Houghton asserts that her work at Freeman is different because she provides design services related to one *exhibition* for one client, rather the providing design services related to individual *exhibits* and events for multiple clients as she did with Plaintiff. While Houghton may not have the exact same role with Freeman that she performed with Plaintiff ... the design services she provides at Freeman are what her work "was concerned with" at Plaintiff's. In both instances, she was in a supervisory role providing design services to clients in the exposition industry. Thus, the services the Houghton now provides ... are "directly concerned" with what she did ... and she violated the Plan's competitive activities provision.

Having found that Houghton violated the Plan's competitive activities provision, the Court also must determine whether Illinois courts would enforce the repayment provision. Generally, Illinois disfavors non-compete provisions in employee contracts. However, in this case, Viad does not seek to enforce the forfeiture clause as an outright prohibition on competition. While Houghton remained free to take whatever employment she chose, the restriction required her to forfeit her bonus if she went to work for a competitor in a similar capacity. The majority view in this country seems to be that a forfeiture for competition clause in an employment agreement is enforceable without regard to the reasonableness of the restraint on the former employee. Most states enforce forfeiture clauses calling for the forfeiture of benefits such as severance pay, stock options, bonuses, pensions, and the like, in the event of competition.

The forfeiture provision in the Plan did not seek the reimbursement of "wages." None of Houghton's salary was tied to her participation in the Plan. The bonus was not regular compensation; to the contrary it was awarded as part of a voluntary program with a string explicitly attached—namely, repayment to the company in the event the Houghton went to work for a competitor. [This provision] does not prevent post-termination employment, but only discourages it by working a forfeiture of an economic advantage. This forfeiture contract leaves Houghton free to make a living as she chooses. Such a choice does not appear to threaten loss of livelihood. A forfeiture clause does not deprive the public of the benefits of competition when,

(Continued)

as in this case, Houghton was able to go into competition despite the clause, and the effect of the clause did not impoverish Houghton, who likely took Freeman's offer only because it compensated for the benefits she had to forfeit upon leaving Viad. Plaintiff's offer—sometimes called “golden handcuffs”—is not a plausible way to monopolize an industry. It did not prevent her from working in her field; instead, it exacted a certain cost on her. Thus, because the clause ... does not appear to be an unreasonable restraint on competition, the Court ... grants Plaintiff Viad's motion for summary judgment and denies Defendant Houghton's motion.

CASE QUESTIONS

1. Houghton had to forfeit the nonsalary bonus compensation according to this trial court—reread the agreement and try to identify any grounds for appeal by Houghton.
2. After this case, are there any further recommendations for Plaintiff, who prevailed in this case, but clearly had time, money, and opportunity costs to this win?
3. Is there anything Viad could have done better to keep Houghton in its employ?

Nonsolicitation Agreements (NSAs)

In this employment covenant, employees agree that during the term of employment and for a designated time thereafter, they will not solicit coworkers, customers, prospective customers, or company vendors when they leave the company for another employer. As an employment relationship ends, departing employees have the right to let these covered groups know about the departure, but they may not solicit business for any new venture they may be undertaking. Issues inevitably arise in litigation concerning the meaning of “solicitation” in instances when a customer or a coworker follows the departing employee to a new venture. To the extent that the customer or coworker is also a personal friend of the departing employee, courts are not inclined to find an actionable claim due to its intertwined nature of the parties' relationship.

Although the period of time in the employment agreement elapsed in this next example (and thus there was no NSA litigation), it becomes apparent how high the stakes are in solicitations of coworkers for new ventures. Jon Rubenstein, credited with conceiving the iPod (of course, known as the “PodFather”), left Apple after reportedly not being able to agree with Steve Jobs on the conception of the keyboard for first-generation iPhones. After the nonsolicitation agreement expired, he accepted an offer to work for Palm. Palm invented smartphones, and after this initial breakthrough success, it rapidly lost market share to RIM's BlackBerry and Apple's iPhone. Struggling and anxious for a second act, Palm hired Rubenstein to head up its Palm Pre overhaul. Rubenstein's Palm team is composed, not surprisingly, of many ex-Apple engineers. Moreover, the Pre is the first non-Apple device to sync to iTunes (it also syncs to iPhoto). Although there are no claims of trade secret misappropriation or illegal employee solicitation, it is apparent how this sort of job mobility can be damaging to companies. The Palm Pre group is perhaps the only unit that could have accomplished this feat of seamless interoperability, clearly at the expense of Apple's proprietary product ecosystem.

Stock Option Agreements

Offering employees company stock or options to purchase stock attracts and retains talented workers, incents them to perform in ways that increase company value, and helps companies cut down on employee turnover and knowledge spillover. This noncash compensation is also ideal for start-ups with severe cash-flow constraints. It is a high-value strategy as well in that it aligns the interests of employers and employees

as a cohesive entity poised to produce the best mix of factors associated with companies' long-term success: innovation, risk taking, compensation, and job security through performance and merit. **Stock option agreements** are technically call options, and give employees the right, but not the obligation, to purchase a certain class of shares in the company, for an agreed-upon cost, known as the *strike price*. Strike prices are individual to each hire, computed at the time the employee is hired, and therefore it becomes a variable (as well as contingent) expense for corporations. When employees exercise their options, employers are obligated to buy that number of shares on the open market at the current market price, and then sell those shares to employees at the agreed-upon strike price. Employees are then free to hold that stock or sell it on the open market. Stock options with a strike price below the current market price are called “in the money,” meaning that the shares of stock are worth more than the contract’s strike price. Stock options with a strike price above the current market prices are called “out of the money,” meaning that the shares of stock are worth less than the contract’s strike price.

Google

As an example, consider Google CEO Eric Schmidt. He received stock options in his 2001 Executive Employment Agreement with a strike price of \$1.20—currently Google shares are trading at around \$400. Clearly these options were in the money! Continuing on with this example, Google shares had a peak price of \$747 in 2007. Over 15,000 Google employees joined the company after this time, during a rapid climb in share price; many of these new hires received stock options with a strike price of \$525. Because the share price fell below the strike price at the time the option matured, their options were out of the money (colloquially known as *underwater options*). Google decided to re-price these options to \$308 per share, resulting in a \$400+ million accounting charge. Of course, affected workers were thrilled, but note that this resulted in a corresponding \$400+ million charge to corporate earnings, while other, nonemployee shareholders did not receive this same benefit.

Other contractual restrictions to these agreements include: probationary periods, restrictions on transfer, expiration dates, repurchase rights for certain trigger events, and so forth. This work for equity saves on salary expense, though option grants must be recognized as a company expense, even for options that have not yet been exercised. Option agreements are a coveted perquisite, but timing is everything. As Google CEO Eric Schmidt said, the theoretical price of these options is a real question for accountants. There are a number of valuation and pricing models used to formulate cost estimates associated with these agreements.

In an attempt to better account for the costs of share-based compensation plans, the Financial Accounting Standards Board (FASB) issued its *Statement of Financial Accounting Standards No. 123, Share-Based Payment* (revised 2004). At 170 pages long, there are a lot of complexities for companies offering such programs. Each contract has different pricing, due dates, etc., and the future is an uncertain place especially with regard to future share price of company stock in start-ups. From a compliance standpoint, companies should be mainly concerned with developing a responsible methodology for expensing options through devising a model or system for estimating the future cost of paying for this employee benefit, as well as complying with public reporting requirements.

This next case addresses a common problem in the tech industry that relies more on human capital than on physical assets. Attracting and retaining employees is a higher priority and more of a challenge in this context; therefore, tech companies typically feature employee stock option plans in their compensation packages.

UNITED STATES v. REYES

**2007 U.S. Dist. LEXIS 66074, 60003, 39619 (2007),
577 F.3d 1069 (9th Cir.), *reh'g denied*,
2009 U.S. App. LEXIS 24574 (9th Cir. Nov. 5, 2009)**

FACTS

During the relevant time (1999–2004), Brocade Communications increased six-fold in size. Gregory Reyes, Brocade’s CEO was extremely concerned with recruiting and retaining employees in a rapidly expanding industry and highly competitive market. He informed the Board of Directors that recruiting and retaining employees was critical, and the best strategy for success would be to offer stock options as a form of compensation to complement the traditional salary-plus-benefits based compensation package. The evidence showed that Reyes knew that stock option grant information should be recorded, and accounted for. But that in order to provide Brocade employees and executives with desirable option grants, these grants needed to appear as if they were below the present market price. So in order to avoid informing shareholders of the consequent millions of dollars in compensation expense that would accrue, Reyes engaged in a scheme with Stephanie Jensen, Vice-President of Human Resources, to grant options below the present market price by falsifying company records to create the false appearance that the options had been granted at the market price on an earlier date (when market prices were much lower).

This caused Reyes and others to materially understate Brocade’s expenses and overstate its income, and Brocade also falsely represented in SEC filings of public reports that it had incurred no expenses for option grants. At trial, the government’s expert, Gerald Fujimoto of Deloitte LLP, estimated the total amount of the fraud on the investing public at approximately \$949 million. Reyes conceded that a scheme to backdate stock options existed at Brocade, resulting in the understatement of compensation expenses on Brocade’s public financial statements but asserted that he did not personally gain from these actions, and there were no resulting injuries. The government’s attorney established that over the four-year scheme, Reyes received in excess of 13 million backdated options, and even with declines in Brocade’s share price, Reyes earned approximately \$2 million.

JUDICIAL OPINION**JUDGE CHARLES BREYER**

A stock option confers a right to buy stock at a fixed price, called the “strike price.” When the strike price is lower than the prevailing price on the stock market, an

option is said to be “in-the-money.” When the strike price is equal to the market price, an option is said to be “at-the-money.” When the strike price is less than the market price, an option is said to be “out-of-the-money.” It is no small feat, however, to figure out how much a stock option is truly worth. At any given point in time, finding the “intrinsic value” of a stock option involves a straightforward calculation: an option is worth the amount by which the market price exceeds the strike price. For instance, if the strike price is \$5, and the shares are trading for \$25, then the option is “worth” \$20. But the clock complicates matters. Markets fluctuate; economies change; companies change. All of these and other variables influence share price, so an option’s worth changes constantly. Further, an option usually does not “vest” until some period of time elapses, and so the recipient cannot exercise it immediately. And there may be an expiration of this right, and there are limitations on transferring these shares.

In short, it is nearly impossible to tell how much a stock option is ultimately going to cost the issuing company. It may cost the company a great deal since the exercise of an in-the-money option requires the company to purchase its own shares on the open market (or to sell treasury stock at a discount). But it may never cost the company a penny, if the option never vests, is never exercised, or is never in-the-money. Thus, to the companies that issue them, stock options are inchoate expenses. The rules of accounting nonetheless require companies to account for the expense of stock options in specific ways. For example, Accounting Principles Board Opinion No. 25 (APB 25) essentially demands that companies tell investors whenever they grant in-the-money options. Moreover APB 25 requires companies to treat such grants as a form of compensation, with the intrinsic value of the grant deducted from revenues like any other expenses. (Companies need not account for at-the-money or out-of-the-money options, which have no intrinsic value at the time they are issued.)

Backdating allows a company to evade APB 25. By retrospectively choosing a favorable historical strike price and then purporting to have granted the option on that previous date, a company can disguise an in-the-money option as having been granted on a date

(Continued)

where the stock price was merely at-the-money, or even out-of-the-money. The company thereby avoids recording a compensation expense, which would have made the company appear, on paper at least, as less profitable.

The issue presented is one of first impression for the federal courts: Does stock options backdating matter to investors? Put another way, the Court must consider whether the information concealed by the alleged backdating scheme at Brocade is “material,” meaning it “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Defendant Gregory Reyes, Brocade’s former CEO, argues that no reasonable juror could reach such a conclusion.

Before turning to the more substantive arguments presented, it is worth refuting some of the observations Reyes has offered about what matters in this case. First, it does not matter that Brocade was, or is, a successful enterprise with substantial cash reserves. Profitable companies, too, owe a duty of honesty to their shareholders. Second, it does not matter whether Reyes himself ever exercised a backdated grant. Undisclosed use of a company’s vault is improper, whether it lines the pockets of the CEO or his employees. Finally, the Court finds little significance in the fact that many of Brocade’s stock options were ultimately cancelled. Reyes repeatedly cites these as merely “hypothetical expenditures.” Yet this argument is akin to the getting caught with a cookie in hand, putting it back in the jar, and speaking of the theft as only “hypothetical.” What ultimately becomes of a backdated option is of limited significance. The law assesses the materiality of a misrepresentation at the time it is made, not after intervening events or remedial action have rendered it harmless. While investors may consider stock option expenses less significant than other financial facts, it does not mean it is immaterial. Investors may care most that a company is profitable, but they may also find it significant and thus material, that a profitable company is meanwhile giving away assets.

To obtain a conviction for securities fraud, the government must persuade a jury that the information withheld from investors is “material.” Reyes contends that the prosecution invited the jury to draw an impermissible inference that Brocade’s backdating scheme was “material” simply because it was dishonest. The chief purpose served by the act of backdating itself is to make the grants look as though they were granted at fair market value, and thereby to avoid a compensation

charge. This is a case about backdating. It is about changing the date on a document to make it look like something happened much earlier than it really did. There are benign explanations for backdating: “The paperwork was catching up with actual events.” And there are nefarious explanations for backdating: “The paperwork was to hide expenses.” The jury’s task was to decide whether the backdating scheme was benign or nefarious. The jurors decided it was the latter, finding the information concealed was material, and reasonable investors would care about such option grants when making investment decisions regarding Brocade. This offense is about honesty. Every time Gregory Reyes falsified documents, repeatedly, he was lying.

[Postscript: Brocade fired Reyes and restated earnings due to backdated stock options in January 2005, widening its 2004 loss to \$32 million (up from \$2 million). Brocade again restated results in November 2005, adding about \$71 million in expenses it hadn’t recorded for options previously issued to executives on leaves of absence or in advisory roles. Brocade also paid a \$7 million fine to settle fraud charges brought by the SEC.

Jensen was convicted in a separate trial and sentenced to prison and ordered to pay a \$1.25 million fine. The jury convicted Reyes on all ten securities fraud charges including one count of conspiracy, four counts of securities fraud, four counts of lying to accountants, and one count of falsifying books and records. Reyes was sentenced to a 21-month jail term and ordered to pay a \$15 million fine. Reyes appealed and a second jury found him guilty of nine charges of fraud and making false statements and acquitted him of a conspiracy charge.]

CASE QUESTIONS

1. Many public companies, reportedly 140 in all, including Apple and Dell, have been investigated for allegedly backdating stock options. How can companies better manage this pressure?
2. What is the effect of this case in terms of the hiring environment in competitive industries?
3. Describe the effect on the company and on current shareholders when employees exercise their stock option grants; in this example, employees have the right to purchase 500 shares at \$1.00 per share, and the open market price for that same stock is \$100.00 per share.

EXHIBIT 10.3 Example of Outstanding, Exercisable, and Vested and Exercisable Stock Options and Warrants for Financial Reporting Purposes

The following table summarizes additional information regarding outstanding, exercisable, and vested and exercisable stock options and warrants at June 30, 2010:

Range of Exercise Prices	Options Outstanding			Options Exercisable		Options Vested and Exercisable	
	Number of Shares	Weighted-Average Remaining Life (Years)	Weighted-Average Exercise Price (unaudited)	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
\$0.30–\$94.80	717,268	4.5	\$ 27.65	696,489	\$ 26.98	587,568	\$ 22.89
\$117.84–\$198.41	952,226	3.5	\$ 177.53	951,678	\$ 177.52	951,678	\$ 177.52
\$205.96–\$298.91	1,010,004	4.0	\$ 274.94	998,445	\$ 274.79	998,445	\$ 274.79
\$300.97–\$399.00	8,230,717	6.5	\$ 309.65	3,471,831	\$ 310.04	3,471,831	\$ 310.04
\$401.78–\$499.07	1,131,674	8.6	\$ 437.70	86,378	\$ 439.42	86,378	\$ 439.42
\$500.03–\$594.05	228,412	4.9	\$ 541.36	141,791	\$ 541.31	141,791	\$ 541.31
\$611.68–\$699.35	6,219	7.1	\$ 627.31	2,055	\$ 649.66	2,055	\$ 649.66
\$710.84	80	7.5	\$ 710.84	50	\$ 710.84	50	\$ 710.84
\$0.30–\$710.84	12,276,600	6.1	\$ 296.43	6,348,717	\$ 260.61	6,239,796	\$ 264.30

The above tables include approximately 1.5 million warrants held by selected financial institutions that were options purchased from employees under our Transferrable Stock Option (TSO) program, with a weighted-average exercise price of \$300.89.

The total grant date fair value of stock options vested during the three and six months ended June 30, 2010 was \$91 million and \$206 million. The total grant date fair value of stock options vested during the three and six months ended June 30, 2009 was \$30 million and \$143 million. The aggregate intrinsic value of all options and warrants exercised during the three and six months ended June 30, 2010 was \$86 million and \$133 million. The aggregate intrinsic value of all options and warrants exercised during the three and six months ended June 30, 2009 was \$104 million and \$211 million. These amounts do not include the aggregate sales price of options sold under our TSO program.

During the six months ended June 30, 2010, the number of shares underlying TSOs sold to selected financial institutions under the TSO program was 326,349 at a total value of \$81 million, or an average price of \$247.41 per share, including an average premium of \$19.74 per share. The premium is calculated as the difference between (a) the sale price of the TSO and (b) the intrinsic value of the TSO, which we define as the excess, if any, of the price of our Class A common stock at the time of the sale over the exercise price of the TSO.

As of June 30, 2010, there was \$899 million of unrecognized compensation cost related to outstanding employee stock options. This amount is expected to be recognized over a weighted-average period of 2.6 years. To the extent the forfeiture rate is different from what we have anticipated, stock-based compensation related to these awards will be different from our expectations.

Employee Separation Agreements

After reading the *Intel v. Hamidi* case, it becomes apparent that separation agreements are necessary to manage the postemployment term. Employee separation agreements are usually signed during the exit interview when employees return company property and receive relevant departure information on unemployment insurance, pension plans, retirement plans, health, or other benefits programs. These agreements cover severance pay if any, along with a host of other clauses, including: a pledge of future cooperation, nondisparagement of the company, confidentiality of company information, noncompetition with the company, and most critically, a release from any present or future claims against the company.

Executive Employment Agreements

These agreements are overseen by an Executive Compensation Committee, usually as part of a subcommittee of the Board of Directors. The agreements are carefully negotiated, and terms include all of the previously discussed agreements as well as others, including: benefits, responsibilities, performance bonus structure, what triggers termination, resignation, change in control of the company, and so forth. One prominent clause in executive agreements is known the *Golden Parachute*—a colorful metaphor for the comfort of a large (taxable) pay-out to executives let go by companies. These clauses are regularly used in industries with a propensity for changes in control, and while much maligned, they have the effect of drawing in top personnel and insulating them as they make strategic management decisions. The goal is to incent innovation by accepting the fact that there are associated risks involved, that new business opportunities, however well-devised, necessarily involved risk which may not result in the desired level of return. Ideally, such incentives should be sufficient to encourage prudent risk taking, yet not so high as to encourage excessive or reckless risk taking. Research points to evidence that the “tolerance for failure

and reward for long-term success is effective in motivating innovation [that] such an incentive scheme [CEOs] explore more, and are more likely to discover a novel business strategy than subjects under fixed-wage and pay-for-performance incentive schemes.”²⁰ This suggests that a mix of long-term incentives is optimum, and therefore that the most successful agreements align corporate goals with executive incentives.

CEO and officer compensation has been studied, criticized, and reported on copiously. There are a few important points worth mention in this era of multimillion-dollar compensation packages, agreed to by compliant (or is it complacent?) boards at the expense of shareholder return and share value, with CEO compensation radically higher in the United States than CEO compensation globally. For example, in 2009 Lawrence Ellison, Oracle’s CEO, taxable earnings were: \$1 million in salary; \$3.5 million as a bonus; \$1.5 million in perks; and \$78 million in exercised stock options. Salaries and bonuses reflect a risk-reward calculus, but the most probative indicia of value, a correlation between executive pay and stock performance, is more useful in assessing the value of the executive management team. The main purpose of the agreements is to optimally align the goals of the company with the executive team, bound together by mutual self-interest and trust.

Summary

Employment in Internet and technology companies is a dynamic and dramatic practice area. There are clashes of powerful ideas, creative visions, and outsize egos in many cases. There is intrigue as employees leave for start-ups. It is not surprising therefore that there is a high company turnover, which fuels demand for employee mobility. Courts and legislatures are called upon to calibrate the relative rights of employers and employees. Employment agreements for the most part attempt to control the employment relationship, and most clauses inure to the employers’ favor, so to the

extent agreements are upheld, employees’ mobility and ability to leverage one’s skills are limited. Innovation likely suffers. However, to the extent such agreements are invalidated, companies incur tremendous losses and wages can get out of control. Here, innovation likely flourishes. Employers must be sure to incentivize employees, through options and other cash and noncash compensation, while also protecting their information in the event that the employees depart. Employment agreements are meant to provide guidelines, benchmarks, and rules for this process.

Key Terms

visitor’s confidentiality and
nondisclosure agreement, p. 301
executive employment
agreement, p. 303
permanent nonofficer employees,
p. 303
subcontractors, p. 304
work for hire, p. 305
shop rights, p. 305

temporary workers, p. 307
E-B (1-5) visa, p. 308
H1-B visa, p. 308
outsourcing, p. 310
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duty of care, p. 311

invention assignment
agreements (IAAs), p. 315
nondisclosure agreements
(NDAs), p. 317
noncompete agreement, p. 318
employee forfeiture
agreement, p. 321
nonsolicitation agreement, p. 323
stock option agreement, p. 324

Manager’s Checklist

- *Human Resources should carefully review present agreements that potential hires are bound to and understand any constraints on hiring that individual.*
- *Managers should make an effort to understand each state’s laws with respect to employment agreements and plan accordingly.*

²⁰Prof. Gustavo Manso and Florian Ederer, Is Pay-for-Performance Detrimental to Innovation?, *Working Paper Series*, June 29, 2010, <http://www.mit.edu/~manso/em.pdf>.

- To the extent managers can control the terms of employment agreements, they will be better able to manage their employee turnover.
- Managers should be prepared to follow-up on departing employees as a way to ensure no company information is being disclosed to the new employer.
- Managers should work closely with the information technology group to identify what each employee needs access to and limit access accordingly.

Questions and Case Problems

1. John Edwards signed an NCA when he began work at Athena Capital. He later resigned from Athena Capital with the intention to go work for Goldman Sachs. Goldman told Edwards they would hire him only if he secured a release from the Athena NCA. After he was unable to (and out of the Goldman job), he sued Athena. *What result can be expected?*²¹
2. Two Merrill Lynch financial advisors, who had signed employment agreements, resigned in order to go to work for Ameriprise Financial. They had given their new employer contact information for their old clients, and Ameriprise sent them announcements that these brokers now worked for Ameriprise. Merrill Lynch immediately filed a lawsuit and requested an injunction based on allegations that they took proprietary business information including client lists, and solicited Merrill Lynch clients. The court considered the four-factor test for issuing an injunction (irreparable harm to plaintiffs; balance of harms; the public interest; likelihood that plaintiff will succeed on the merits of the case). *What result can be expected?*²²
3. Immunomedics was alerted that there was some negative buzz about the company in a chat room. The poster used a pseudonym, and therefore the company was unable to identify the poster for lawsuit purposes. The only information the company could ascertain was the poster's ISP. So the company decided to subpoena the ISP for identity information of the poster in order to file suit against the poster. *How should courts handle these cases, where the company's complaints may, or may not rise to the level of an actionable legal claim?*²³
4. Monster.com hired some individuals, and the company selected a low stock closing price that they wanted to grant options at. Then other employees prepared backdated documentation for the compensation committee. The SEC filed suit, alleging that the company understood the consequences of granting these in-the-money options would have on its public filings and financial accounting reports, yet issued them anyway. The SEC charged the company with making materially false and misleading statements. *What result can be expected?*²⁴
5. Defendant William Becker worked for APC Filtration, and then left that job to go work for another company. He had communicated information about APC prior to leaving APC. APC filed suit, alleging that Becker signed an NDA and that he breached this agreement. (Just after the suit was filed, Becker drove 20 miles and threw his computer in a construction site dumpster in a effort to prevent APC from discovering potentially damaging evidence.) Becker also defended these charges, asserting that while there might have been an NDA with his original compensation agreement, his agreement was revised over the years, and a new NDA was never attached to these revised copies. Becker argues therefore that he is not subject to any NDA. APC countered that the original NDA was in force at all times, even after Becker left the company. *What result can be expected?*²⁵

²¹*Edwards v. Athena Capital Advisors, Inc.*, Civ. Action No. 07-2418-E (Mass. Super. Ct. 2007).

²²*Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Baxter*, 2009 U.S. Dist. LEXIS 31326 (D. Utah 2009).

²³*Immunomedics, Inc. v. Doe*, 342 N.J. Super. 160 (2001).

²⁴*SEC v. Monster Worldwide, Inc.*, No. 09-Civ-4641 (S.D.N.Y. 2009), <http://www.sec.gov/litigation/complaints/2009/comp21042.pdf>.

²⁵*APC Filtration, Inc. v. Becker*, 2009 U.S. Dist. LEXIS 5944 (N.D. Ill. 2009).

Additional Resources

- Information Technology Association of America, <http://www.ita.org/>
- US Citizenship and Immigration Services, employer information, <http://www.uscis.gov/portal/site/uscis>
- Alliance for Open Competition, <http://opencompetition.wordpress.com/>
- *Tech Recruiting Clashes with Immigration Rules*, <http://www.nytimes.com/2009/04/12/business/12immig.html>
- *America's Loss Is the World's Gain: America's New Immigrant Entrepreneurs, Part 4*, by Vivek Wadhwa, AnnaLee Saxenian, Richard B. Freeman, and Gary Gereffi, March 2, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1348616