

LEGAL STRATEGIES FOR EMPLOYEE RETENTION

Retaining good employees will become an even more critical task for employers in future years. Shortages of qualified, skilled employees loom in the not too distant future due to the changing demographics of an aging workforce. Moreover, the healthy economy and different notions of loyalty allow qualified workers to change jobs far more frequently than in the past. This edition of the *Employment Law Advisor* examines this employer challenge and offers creative legal strategies for increasing employee retention.

THE UPCOMING EMPLOYEE SHORTAGE

Although human resource personnel and employment counsel often focus on the need to discipline and sometimes discharge problem employees, on the flip side of the coin is the need to retain good employees. Employee retention is critical to business success; the costs of employee turnover are high, even when a qualified applicant is waiting to take the departing employee's place. These costs include the need to interview and train the new hire, and integrate him into the company's team. Further, the adage "the devil you know is better than the devil you don't" is certainly true in hiring: a new hire is often an uncertain investment – the very person who seemed so talented in an interview may turn out to be unqualified or difficult to manage. There are also other costs when an employer loses staff – disruption, decreased morale, and possible poaching by the departing employee, who may have moved on to what other employees believe is a greener pasture. The costs associated with employee departures will rise even further as qualified replacement employees become harder to find. Prudent employers will do everything they can, from both a human resources and a legal standpoint, to retain current employees and avoid the costs of employee departures.

The U.S. Department of Labor's Bureau of Labor Statistics ("BLS") has predicted that there will be fifty-six million job openings between 2002 and 2012. These openings will stem from both employment growth (the creation of new jobs) and replacement needs, which arise when workers leave occupations. See <http://www.bls.gov/oco/oco2003.htm>. While replacement needs will account for approximately 60 percent of the job openings, professional and related occupations (including computer, mathematical, healthcare and technical occupations) are projected by the BLS to grow faster and add more jobs than other occupational groups – adding 6.5 million new jobs by 2012.

These changes are a result not only of a healthy economy, where employees feel capable of switching jobs if they become unhappy with their current position, but the approaching

enormous demographic change caused by the retirement of the "baby boomers." As the baby boomers age and become eligible for retirement (or stop working due to disability or death), the number of people in the primary working age group, between 25 and 54 years old, is projected to shrink, leaving employers with fewer skilled workers to fill an increasing number of job openings. See <http://www.bls.gov/oco/oco2003.htm>.

What does this mean for employers? Instead of assuming that employees are satisfied just to have a decent job, employers must face the reality that their workers have an increasing number of options, and qualified applicants will become more difficult to find in coming years. Careful planning now can help employers retain good employees, and keep new ones longer.

RETENTION STRATEGIES

Human resources specialists have long studied the factors which contribute to an employee's happiness and result in employee retention. For example, two well-known writers in this field, Beverly Kaye and Sharon Jordan-Evans, have found that in addition to fair pay, employees want challenging, meaningful work, a chance to learn and grow, great co-workers, recognition and respect, and a good boss. See *Love 'Em or Lose 'Em: Getting Good People to Stay*, Beverly Kaye and Sharon Jordan-Evans, 3rd edition (2004), page xv. In addition to these important job satisfaction issues, there are creative legal strategies employers can implement to increase employee retention.

GOLDEN HANDCUFFS

So called "golden handcuffs" refer to contractual agreements that subject a portion of an employee's compensation to vesting, often over a period of years, as an incentive for the employee to remain employed. For example, it has become increasingly common for employers to offer stock options as a part of a compensation package. When the stock options offered vest over a period of three or four years, the employee is motivated to remain with the company (at least as long as the employee believes the options are valuable).

Another alternative is to offer an employee restricted stock that cannot be sold for a period of years and which can be bought back by the company at a price less than fair market value if the employee leaves within that period of time. Restricted stock can be offered to employees subject to vesting conditions similar in nature to those used with option plans (discussed above). The employee is therefore motivated to remain with the employer until the vesting period or other conditions have been achieved, in order to avoid below market repurchase of the stock by the employer.

Another approach is to include a severance provision in an offer letter or employment agreement whereby the employee's right to severance vests over a period of years. For example, if the severance entitlement vests over four years, an employee who leaves within one year gets nothing, but an employee who sticks it out for the entire period is rewarded with an entitlement to the full amount of the promised severance.

TAX CONSEQUENCES OF DEFERRING COMPENSATION

The tax benefits of deferring compensation that is earned and vested may also provide an incentive for the employee to remain with the company. For example, an employer may hold back a percentage of salary compensation earned by an employee (such as a bonus). The employee will not be taxed when the compensation is earned, rather he will be taxed when the compensation is paid out to him or on his behalf. Employees benefit not only from paying the tax liability in "tomorrow's dollars," but also by deferring the tax liability to a time (such as retirement) when they may be in a lower tax bracket. The employee is therefore motivated to remain with the employer to achieve these tax benefits.

Before putting any deferred compensation plan into place, however, an employer should ensure that the plan complies with the deferred compensation tax rules of the Internal Revenue Service, which have changed drastically over the last year. Failure to adhere to these rules will not only result in current income taxation, but potentially an additional twenty percent penalty plus interest.

GOLDEN PARACHUTES

"Golden parachutes" are benefits given to key executives in the event that their company is taken over by another firm. When a company is in a volatile industry, it can be very helpful to include this type of provision in an executive's employment agreement as a strong incentive for employees to remain during uncertain times. A golden parachute can include any type of compensation, including stock options and severance pay.

As with deferred compensation, the employer must be aware of harsh tax rules associated with golden parachutes. Excessive golden parachute payments made to certain "disqualified individuals" may result in a reduced compensation deduction to the employer and a twenty percent penalty on a portion of the payment imposed on the employee.

RESTRICTIONS ON COMPETITION AND CUSTOMER SPECIFIC PENALTIES

An enforceable non-compete agreement can often be an excellent employee retention tool, as it decreases the employee's options for alternate employment. An employee who faces a legal obstacle to taking employment with a competitor may have second thoughts about jumping ship, and may be motivated to work to improve his or her current position instead of trading it for a new one. Of course, there are limitations on an employer's ability to restrict employees from working for other companies. The steps employers can take to enhance their ability to enforce their non-compete agreements are discussed in MBBP's September 2004 ELA.

See http://www.mbbp.com/practices/employment/ela/ela_0904-non_competes.pdf

A similar effect can be achieved in appropriate industries by entering into an agreement with an employee whereby the employee agrees that if he or she wants to continue doing business with specific customers after separating from the company the employee will pay a fee to the company (often described as a significant percentage of the company's revenue or billings generated by the customer in the past year). This customer specific penalty gives sharp teeth to more commonplace non-solicit agreements, and may act as an effective deterrent against employee departures.

EMPLOYEE BENEFIT PROGRAMS

Employers should consider the use of benefits beyond traditional vacation and health insurance policies to increase employee loyalty. By offering these programs only to employees who have worked a certain number of years for the company, remaining with the company is encouraged. For example, a properly drafted tuition reimbursement program can be an attractive opportunity for employees to enrich themselves while continuing to be productive employees. Employers might also consider offering a "sabbatical" leave of absence to allow employees who have already put in a number of years of service to travel or pursue an interest or hobby for a month or more, and return to work refreshed (instead of feeling like this type of break can only be accomplished between jobs). Flex-time, part-time and telecommuting programs are also coveted benefits which, if structured properly, can result in the retention of good employees (including those with young children) who might otherwise choose to leave.

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