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LABOR & EMPLOYMENT

ALERT

TIPS FOR PROTECTING YOUR COMPANY BEFORE A SCANDAL STRIKES

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In today's competitive economy, it is imperative for companies to build and maintain a positive reputation and image in the marketplace. To do so, companies spend millions of dollars each year on a variety of brand building activities to demonstrate to the public that they are honest and trustworthy and that their services and products are valuable and should be purchased.

However, history has shown that a company's expensive and time consuming efforts to build a positive reputation can be seriously damaged in an instant when a scandal involving a high level executive strikes, as an executive's misdeeds are often attributed to the company. Unfortunately, examples of high level executives engaging in inappropriate actions, whether on or off duty, are commonplace and cut across every industry and sector. Further, there is no indication that scandalous behavior will abate any time soon as shown by the numerous recent scandals involving illicit affairs, insider trading, fraudulent bookkeeping and overbilling practices and other scams. Complicating matters is that, even when the best monitoring systems and public relations response plans are in place, scandals are unpredictable and often come to light only after significant damage has been done.

To deal with this uncertainty, companies should perform thorough background checks before hiring an executive. In performing background checks, companies should not only check an individual's credit history but also should conduct a broader search of any public records regarding litigation and/or bankruptcy filings for the applicant's current and former employer. Such filings may have useful information regarding the executive's prior performance. While performing such searches companies must be careful to comply with the Fair Credit Reporting Act and any other state or local laws that address the use of driving records, criminal records, and/or credit histories etc.[1]

A company also can promote good behavior by adding a "morals clause" to the executive's employment agreement. A traditional "morals clause" is a contractual provision that gives an employer the unilateral right to terminate the employment agreement or take punitive action against the employee in the event that the employee engages in reprehensible behavior or conduct that may negatively impact the company. These clauses are often a part of the "termination for cause" provisions in the executive's employment contract. For instance, the "for cause" termination language in an employment contract could provide that the executive will be subject to termination for: (1) engaging in activities or conduct injurious to the reputation of the company or its affiliates including, without limitation, engaging in immoral acts that become public information, (2) committing an act of dishonesty, including, but not limited to,

misappropriation of funds or any property of the company, and (3) committing a misdemeanor involving an act of moral turpitude or a felony.

Additionally, a company can link its "morals clause" to the executive's deferred compensation package. In a nutshell, the executive's agreement can provide that if he/she violates the "morals clause" they forfeit all or a portion of the deferred compensation they would otherwise be entitled to in addition to whatever other legal action may be taken against them. Likewise, a company can require an executive to pay for the full cost of their own health insurance if they violate the "morals clause." Directly tying the executive's future compensation to good behavior is also a proven powerful incentive to act ethically and in accordance with the company's standards of conduct.

Similarly, the executive's employment agreement could explicitly provide that the company, in its sole discretion, can refuse to defend and hold the executive harmless and/or to indemnify the executive if it determines that he or she violated the company's code of conduct, ethics policy and/or "morals clause." Such a clause in an agreement may not be allowed in jurisdictions (such as California) that impose a statutory duty to indemnify. But where permitted, they should make executives think twice before engaging in inappropriate behavior since their own assets will be at risk if they step out of line.

Unless explicitly prohibited, courts should uphold the foregoing clauses where they are clear, specific and unambiguous and not unduly broad or vague based on the well-settled notion that individuals have the freedom to enter into contracts to order their own affairs. Restatement (Second) of **Contracts** ch. 8, introductory comment. (1981).

By adding a carefully drafted "moral clause" provisions to an executive's employment agreement, a company will not only be sending a clear message to the executive of what is expected of him or her but also be providing itself with the ability to limit the damage in the event a scandal strikes. Further, adding such a clause should reduce the likelihood that an executive will engage in misconduct while encouraging ethical and responsible behavior thereby protecting and enhancing the company's public image and reputation.

As with drafting any contract, there is substantial room for error. Hence, if questions arise when preparing an executive's employment agreement to incorporate a "morals clause" or otherwise, it is advisable to contact qualified counsel to have it reviewed to ensure the agreement will be enforceable when needed.

If you have questions about this Alert, please contact Kenneth A. Rosenberg at 973.994.7510 or krosenberg@foxrothschild.com or any member of Fox Rothschild's Labor and Employment Department.

1 For instance, the City of Newark, recently passed Ordinance 12-1630 which provides that employers with more than 5 employees may not run criminal background checks until after a conditional offer of employment is made and may only run checks on those working in "sensitive" positions. In addition, California law (e.g. Civil Code §1785.20.5 and Labor Code § 1024.5) limits when and how employers may obtain credit reports on prospective employees.

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