

In This Issue:

November 2009

The California Supreme Court finds valid a forfeiture provision in a restricted stock plan, even though the plan is funded from employees' wages.

The Contractual Basis of Incentive Compensation Re-Emphasized: Restricted Stock in Lieu of Cash Wages Can Be Forfeited By Resignation in California

By R. Brian Dixon and Ellen N. Sueda

In *Schachter v. Citigroup, Inc.*,¹ the California Supreme Court rejected claims that an incentive plan that conditioned the earning of restricted stock based on continued service was unlawful where the employee voluntarily elected to participate in the plan, and the employee quit before the date on which the incentive was earned. The plan was lawful even though the incentive plan was funded from wages that the employee would have otherwise received in cash. With this decision, the California Supreme Court joined the courts of six other states that had concluded the Citigroup Capital Accumulation Plan complied with each state's respective wage payment laws.²

Background

David B. Schachter, a former employee of Smith Barney, Inc., which at all relevant times was a subsidiary of Citigroup, Inc. (the "Company"), was a participant in the Company's Capital Accumulation Plan (the "Plan"). Under the Plan, selected employees could voluntarily elect to receive restricted stock in lieu of a portion of their cash wages. An eligible employee could elect to receive up to one quarter of his or her compensation for the following year in the form of restricted stock. The designated amount was used to purchase restricted stock at a 25% discount from its market value. The stock could not be sold, assigned or otherwise transferred until the stock vested. A participant had the same voting and dividend rights immediately on the award of restricted stock as would an ordinary stockholder. In order for the stock to vest, an employee was required to continue in employment for a period of two years. If a participant voluntarily terminated employment or the Company terminated his or her employment for cause before the end of the two-year vesting period, the restricted stock would be forfeited. If a participant was involuntarily terminated without cause prior to the end of the vesting period, the participant would receive a cash payment equal to the amount used to purchase the restricted stock.

Schachter elected to participate in the Plan, but prior to completing the two-year vesting period, he voluntarily terminated his employment. Despite the clear language in the

Plan and election form, Schachter filed a class action against the Company alleging the stock forfeiture violated a number of California Labor Code provisions and constituted an unlawful conversion of wages.

The Contractual Basis of Incentive Compensation

The California Supreme Court resolved the matter by emphasizing the contractual nature of an employee's compensation, apart from that which is specifically regulated by statute, such as the minimum wage. When Schachter voluntarily elected to participate in the Plan, he elected to divide his wages into two components. One component was wages that would be paid in cash. The other component was wages that would be paid as restricted stock.

The California Supreme Court recognized that incentive compensation can act as an inducement for future and productive service, and that incentive compensation is not earned until all of the conditions to receiving such compensation are met.³ Schachter's right to receive the stock was, accordingly, subject to the requirement that he complete the two-year period of employment after he was awarded the restricted stock. When Schachter voluntarily terminated his employment prior to the end of the required two-year vesting period, he forfeited his contingent ownership interest in the stock. As a result of the forfeiture, there were no earned and unpaid wages due at Schachter's termination. Schachter could not, therefore, successfully argue that he had failed to receive all of the compensation due upon the termination of his employment in violation of section 201 of the California Labor Code or that he had returned earned compensation to his employer in violation of section 221. As the incentive had not been earned, there could be no argument that the Company had attempted to contravene the California Labor Code by private agreement in violation of section 219 or that the Company had converted the employee's compensation.

The contractual underpinning of the decision appears to provide an employer with great flexibility in structuring the compensation of employees, including the forfeiture of such compensation. An at-will employee who is given notice of a change in compensation and then continues to work is deemed to have accepted the change.⁴ An employee who is notified that some of his or her compensation *that may be earned in the future* will be received through cash and some through the opportunity to participate in an incentive plan is likely bound to that arrangement if the employee continues in employment. Yet, the circumstances at issue in *Schachter* are obvious: participation in the plan was voluntary, the participants were sophisticated financial industry employees, and the plan provided substantial economic benefits to counterbalance the risk of forfeiture. It remains to be seen whether other courts will apply the result to more varied circumstances or whether the result will be limited to the circumstances at issue.⁵

What Wasn't Discussed by the Court

The decision may be most noteworthy for what it doesn't say. The decision that the employee had elected to divide his compensation into two components allowed the Supreme Court to avoid addressing whether the amount used to purchase stock should be subject to more rigorous scrutiny as a deduction from wages. Because the amount used to purchase restricted stock was dependent upon and would vary with the employee's regular earnings, the amount could be characterized as a deduction from wages. Courts in Massachusetts and New Jersey had found the specific provisions in their respective states wage payment laws that allow deductions to participate in stock purchase plans to support the lawfulness of the Plan.

The California Supreme Court decision also contained no discussion of the distinction between the condition precedent to earning an incentive in *Niesendorf* and the forfeiture of a contingent ownership right in *Schachter*. Forfeitures are generally more strictly scrutinized than conditions precedent. Other states' courts had found the forfeiture provision to merit separate discussion. The decision likewise makes no reference to public policy considerations. Again, other states' courts had scrutinized the public policy implications of the Plan.

The California Supreme Court also did not discuss the relationship between cash wages and wages paid in kind. Section 212 of the California Labor Code sets standards for the cash payment of wages and contains no exclusions from its requirements. The California

Court of Appeal had concluded that section 212 of the California Labor Code applied only to cash wages and that wages could be paid in kind, such as restricted stock. As the definition of wages expands, potential conflicts may emerge between the provisions of the California Labor Code that are implicitly focused on the mechanism for making the payment of wages in cash and the payment of wages in other forms. The absence of discussion of some of these issues may be a consequence of the broad definition of wages adopted by the California Supreme Court - once wages are defined broadly, it is difficult to reconcile the typical aspects of incentive compensation with the portions of the California Labor Code that are focused on paying wages in cash.

Perhaps most telling is that the California Supreme Court's decision makes no reference at all to any of the decisions by the courts of the other states related to the same issue, which in some cases address the very same Plan. This omission emphasizes the state-specific analysis that must be undertaken to ensure that an incentive plan complies with all of the laws that protect the employees who will participate in the plan.

What Is a Wage?

The broad definition of a wage may pose issues for employers in other contexts. The only aspect of an employee's compensation that has been specifically found not to be a wage is a stock option.⁶ The rationale for that decision, that a stock option is not a wage because it has no value,⁷ was not tested in the *Schachter* decision. The exact dividing line between a wage and non-wage benefits remains to be defined. In a previous case, the California Supreme Court had noted that there may be some incentives that might not be considered a wage.⁸ In *Schachter*, the Company did not argue that the restricted stock was anything other than a wage. Other courts, under the laws of their respective states, have found a variety of incentives not to be a wage, and one found restricted stock not to be a wage.⁹

One form of equity compensation that may be at risk for being found to be a wage under the *Schachter* analysis is restricted stock units (RSUs). RSUs are similar to restricted stock, but no stock is issued at the time of grant, only a right to receive stock and/or cash at the value of the stock at the time of vesting; however, RSUs typically have no dividend or voting rights. As such, RSUs fall midway between the restricted stock that was at issue in *Schachter* and the stock options that the Ninth Circuit Court of Appeals found not to be a wage.

Recommendations

In light of the California Supreme Court's decision, employers with employees in California who wish to establish an incentive program similar to the Plan should consider the following recommendations to help ensure that the forfeiture provisions will not violate the California Labor Code:

- The terms and conditions of the incentive program should be in writing with material terms fully disclosed to eligible employees prior to enrollment. Most importantly, all forfeiture provisions should be clearly and unambiguously disclosed.
- Notification of or enrollment in incentive programs should occur prior to the beginning of the performance period during which the incentive is earned.
- Employees should consent to their participation in the plan in writing on an enrollment form and expressly acknowledge their consent to the forfeiture provisions.
- Forfeiture should only apply if the employee resigns or is terminated by the company for cause. The term "for cause" should be specifically defined in the enrollment agreement.
- Consider providing pro rata payment or vesting for involuntary terminations not for cause. Make sure that the effect of a termination without cause is considered when planning layoffs.

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R. Brian Dixon and Ellen N. Sueda are Shareholders in Littler Mendelson's San Francisco office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Mr. Dixon at bdixon@littler.com, or Ms. Sueda at esueda@littler.com.

¹ *Schachter v. Citigroup, Inc.* (S161385), 2009 Cal. LEXIS 11056 (2009).

² *Kim v. Citigroup, Inc.*, 368 Ill. App. 3d 298 (2006); *Weems v. Citigroup, Inc.*, 453 Mass. 147 (2009); *In re Citigroup, Inc., Capital Accumulation Plan Litigation*, 535 F.3d 45 (1st Cir. 2008) (addressing Florida and Georgia law); *In re Citigroup, Inc., Capital Accumulation Plan Litigation*, 2008 U.S. Dist. LEXIS 64100 (D. Mass. 2008) (addressing Texas law); *Weems v. Citigroup, Inc.*, 289 Conn. 769 (2008) (addressing Connecticut law); see also *Marsh v. Prudential Secs. Inc.*, 1 N.Y.3d 146, 770 N.Y.S.2d 271 (2003).

³ *Neisendorf v. Levi Strauss & Co.*, 143 Cal. App. 4th 509 (2006).

⁴ *DiGiacinto v. Ameriko-Omserv Corp.*, 59 Cal. App. 4th 629, 637 (1997).

⁵ The California Supreme Court took pains to point out that the result might have been different had an employee been involuntarily terminated without cause. The California Supreme Court endorsed in dicta that an employee who is terminated when there are no further services to be performed in order to earn a commission cannot be denied the commission. That cautionary note must be considered carefully by employers when designing incentive plans and considering what conditions an employee must fulfill in order to earn an incentive. The California Supreme Court suggested that continued employment could not be a condition to earning a commission if all of an employee's expected duties had been accomplished before termination. The exact relationship between an incentive that is calculated in some relationship to sales, but which is also conditioned on continued service, remains to be addressed.

⁶ *International Business Machs. Corp. v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (This conclusion of the 9th Circuit Court of Appeals that stock options were not wages in California has been followed by the California Court of Appeal. See *Dubbs v. Net Value Holdings*, 2003 Cal. App. Unpub. LEXIS 999.).

⁷ Ironically, the current accounting rules relating to stock options disagree and require that companies take into consideration the value and expense of stock options in its financial statements.

⁸ *Prachasaisoradej v. Ralphs Grocery Co.*, 42 Cal. 4th 217 (2007).

⁹ *Guiry v. Goldman Sachs & Co.*, 814 N.Y.S.2d 617 (2006).