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California Supreme Court Upholds Forfeiture of Incentive Compensation

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In a closely watched case involving the Smith Barney Capital Accumulation Plan, the California Supreme Court has ruled unanimously that state law does not prohibit an employer from forfeiting an employee's incentive compensation when the employee quits or is terminated for cause before the date that the compensation vests. *Schachter v. Citigroup, Inc.*, No. S1611385, 2009 Cal. LEXIS 11056 (Nov. 2, 2009).

But in *dicta*, the court suggested an exception to its ruling: If an employee is terminated without cause, then the employee still may be entitled to a *pro rata* share of the compensation at issue. The court did not elaborate on what would constitute "cause" in this context, whether the reason for the termination would make a difference, or whether an express provision in the incentive-compensation plan would eliminate the potential exposure. It therefore is unclear how far this exception may go.

For California employers that have incentive-compensation plans with forfeiture provisions, as well as those employers considering adopting such plans, *Schachter* is required reading to ensure that the plans are properly drafted to be enforceable under state law, and that the decision whether to pay out incentive compensation in a particular case is lawful.

The Smith Barney Capital Accumulation Plan

The Smith Barney Capital Accumulation Plan permitted eligible employees to elect at the end of each year to forgo part of their pay in the next year in return for an award of restricted company stock equal in value to 133% of the forgone pay. Restricted stock could not be sold, transferred, pledged, or assigned for a two-year period commencing on the date of the award. But during that restricted period, participating employees had the right to vote the shares and would receive regular dividends on the stock.

If an employee remained in the company's employ for the two years following the award of the restricted stock, the shares vested fully, free of any restrictions. However, if the employee quit or was fired for cause before the end of the two-year period, the employee completely forfeited the stock, as well as the percentage of income the employee designated to be paid in stock. In contrast, if an employee was involuntarily terminated without cause, the employee forfeited the stock, but received in return, without interest, a cash payment equal to the income the employee designated to be paid as stock.

The Schachter Litigation

Plaintiff David Schachter, a Smith Barney stockbroker, enrolled in the Plan in 1994. Pursuant to his elections, in 1995 Schachter received restricted shares with a 1997 vesting date, and in 1996 he received additional shares with a 1998 vesting date.

In 1996, Schachter quit Smith Barney. Because Schachter's resignation occurred prior to the vesting dates of his restricted stock, he forfeited all of the stock, as well as the portions of his compensation he had directed be paid to him in the form of the stock.

In May 1998, Schachter filed a class action against the company alleging that (1) the Plan's forfeiture provision violated California Labor Code sections 201 and 202, which require the prompt payment of all earned wages when an employee is terminated or when an employee resigns; (2) the Plan's forfeiture provision violated Labor Code section 221, which prohibits an employer from collecting wages back from an employee; and (3) the forfeiture of the compensation he elected to receive in stock constituted the unlawful conversion of wages.

In the course of years of litigation, the trial court certified a class but, ultimately, granted summary judgment in favor of the company. The Court of Appeal upheld the summary judgment. The California Supreme Court then granted review and, in a unanimous decision, affirmed the judgment below.

The Supreme Court's Opinion

The court first considered Schachter's claim that the restricted stock constituted wages that, under California law, had to be paid to Schachter upon his resignation. Citing numerous past precedents that broadly define "wages," the court agreed that incentive compensation, including restricted stock, constitutes wages under the law.

However, the court disagreed with Schachter's contention that because the restricted stock was a kind of wages, the compensation he had elected to receive in stock had to be paid to him upon his resignation. The court held that Schachter and Smith Barney were free to agree prospectively on the terms of Schachter's incentive compensation, including a condition precedent to its payment. By enrolling in the Plan and executing the Plan election forms, the court held, Schachter agreed to accept incentive compensation that was at risk of forfeiture if he left Smith Barney or was terminated for cause within the two-year vesting period. The court stated that it is lawful to pay compensation intended to provide an incentive for the employee's continued employment, subject to the condition that the compensation is forfeited if the employee quits or is fired with cause before the compensation vests. In that instance, the court explained, the employee has not kept his or her part of the bargain—the employee has not continued with the employment through the vesting date—and therefore has not earned the compensation.

Accordingly, the court concluded that because Schachter had not earned the wages represented by his unvested restricted stock—because he had not continued to be employed throughout the two-year restricted period due to his early resignation—the forfeiture of his stock pursuant to the Plan did not constitute an unlawful forfeiture of wages, and Smith Barney did not have to pay to Schachter the cash compensation he had agreed to receive in stock.

The court also rejected Schachter's argument that that his incentive compensation, like vacation pay, should vest on a *pro rata* basis, entitling him to at least some payment upon resignation. The court said that the voluntary incentive compensation at issue here was not the same as vacation pay because "vacation pay begins vesting as soon as the employee has performed substantial services for his or her employer." Further, "vacation pay is not an inducement for future services, but is

compensation for past services." By contrast, "the purpose of incentive compensation is to serve as an "inducement to employees to procure efficient and faithful service."

Significance of Schachter for Employers

Under *Schachter*, California employers now have the opportunity to design or defend incentive-compensation plans with enforceable forfeiture provisions.

Although *Schachter* involved restricted stock, nothing in the opinion so limits its ruling. Other kinds of incentive compensation, including cash bonuses, commissions, stock options, and the like, should receive equal treatment when it comes to forfeiture provisions. The key is to design the plan to make clear the compensation is intended as an incentive for continued employment and future service, and not merely to reward past service. Well-written plans make this essential distinction.

At the same time, employers must be careful not to get carried away with incentive-compensation plans. For one thing, even if some compensation is treated as incentive pay, an employee still must receive sufficient cash wages to satisfy the legal requirements to pay minimum wage, overtime compensation, and, in the case of most exempt employees, salary.

In addition, the Supreme Court in *Schachter* emphasized the voluntary nature of the Plan—Schachter expressly agreed to the terms of the Plan, including its forfeiture provision, and elected to be paid compensation as restricted stock pursuant to the Plan. Thus, having an express written agreement by the employee to the terms of an incentive-compensation plan could be helpful in defending its forfeiture clause. However, the court did not say that the employee's express agreement to an incentive-compensation plan is required. Indeed, the court reaffirmed the principle that in an at-will employment relationship, an employer may unilaterally change future terms and conditions of employment provided that the change does not violate a statute or breach an implied or express contractual agreement. *See Scott v. Pacific Gas & Electric Co.*, 11 Cal. 4th 454, 464-65, 904 P.2d 834, 46 Cal. Rptr. 2d 427 (1995); *DiGiacinto v. Ameriko-Omserv Corp.*, 59 Cal. App. 4th 629, 637, 69 Cal. Rptr. 2d 300 (1997). This indicates that an at-will employer unilaterally could adopt a prospective incentive-compensation plan with a forfeiture provision, and continued employment by the employee would be deemed acceptance of the plan.

Caution: A Possible Exception

Employers also should be wary of a possible exception to the forfeiture rule upheld by the Supreme Court that is implied by *dicta* in the court's opinion. The court noted that under the Plan, had Schachter been fired by Smith Barney without cause, he still would have forfeited the restricted stock, but he would have been paid an amount of cash equal to the portion of his income he had elected to receive as stock. Even though the court did not need to say more, it went on to describe this provision of the Plan as "consistent with contract law principles prohibiting efforts by one party to a contract to prevent completion by the other party." Quoting guidance by California's Division of Labor Standards Enforcement, the court wrote, "If the employee is discharged before completion of all of the terms of the bonus agreement, and there is not valid cause, based on conduct of the employee, for the discharge, the employee may be entitled to recover at least a pro-rata share of the promised bonus."

The court did not elaborate on what would constitute "valid cause" in this context, but its reference to the "conduct of the employee" raises a number of questions. Employees may argue that cause to terminate exists only if the employee is at fault for his or her discharge, such as because of poor performance, violation of workplace rules, or misconduct. Employers could counter that sometimes cause to terminate exists when the employee is not at fault, such as in a reduction in force. *See, e.g.*, *Gard v. American Telephone & Telegraph Co.*, 76 F.3d 386 (9th Cir. 1996); *Clutterham v. Coachman*

Industries, Inc., 169 Cal. App. 3d 1223, 215 Cal. Rptr. 795 (1985). Cause to terminate also exists when the employer has a good-faith belief that the employee engaged in misconduct, even if it turns out the employee did not. *Cotran v. Rollins Hudig Hall Int'l, Inc.*, 17 Cal. 4th 93, 948 P.2d 412, 69 Cal. Rptr. 2d 900 (1998). Employers also could contend that *Schachter* does not preclude an incentive-compensation plan from expressly denying *pro rata* payouts in the event of a RIF or a termination without cause, however defined, or that provides for *pro rata* payouts for non-cause terminations while incorporating a good-faith standard for determining cause.

One could make the case that once employment terminates, regardless of the reason, the objective of providing incentive compensation—to receive the benefit of employee's continued services through the vesting period—cannot be achieved, and therefore the compensation is no more earned in the event of a termination without cause than if the employee had quit or was terminated with cause. Moreover, when an employee is terminable at will, then he or she has no legal right to continued employment, and it is difficult to understand why an employer exercising its legal right to terminate at will becomes liable to pay an amount that was supposed to be payable only if the employee remained in the employer's employ through the vesting period.

The Supreme Court implied that this argument may not prevail because of the general principle that a party may not frustrate the performance of a contract by the other party. But nowhere in its opinion did the court reconcile this principle with the employer's right to terminate at will. If the court was worried that employers would read its opinion in *Schachter* as permitting them to terminate an employee close to the vesting date of incentive compensation for the purpose of avoiding the payment of the compensation to the employee, it surely could have articulated a more limited rule—such as pronouncing that under the covenant of good faith and fair dealing, an employer may not terminate employment for the purpose of avoiding payment of compensation that otherwise would have come due. Indeed, nearly a decade ago, the court alluded to such a rule, albeit again in *dicta*. *See Guz v. Bechtel National, Inc.*, 24 Cal. 4th 317, 353 n.18, 8 P.3d 1089, 100 Cal. Rptr. 2d 352 (2000).

How lower courts will read the *dicta* in *Schachter* remains to be seen. In the meantime, employers should consult counsel to ensure that their incentive-compensation plans are drafted to take advantage of the *Schachter* ruling upholding forfeitures and to address the potential implications of the *dicta* in the opinion. And based on the lack of clarity in the law, employers should consider their options in the event of a termination without cause, including paying a *pro rata* share of the otherwise-forfeited compensation; negotiating for a partial payment case by case; or holding firm that nothing is owed.

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