Executive Compensation Litigation

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EXECUTIVE COMPENSATION LITIGATION

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Marital Property


In determining what portion of unvested stock options to include in a marital estate, the court in *Baccanti, supra*, concluded that unvested stock options were part of the marital estate even where they granted for past services performed prior to the marriage. In particular, the court, in applying a time rule for determining the number of unvested options to be included in the marital estate, rejected the majority rule whereby unvested options are apportioned based on a comparison of (a) the time the employee both owned the options and was married, and (b) the time from issuance of the options to vesting. Because, under Massachusetts law, property acquired prior to a marriage may be included in the marital estate, the court modified the time rule by multiplying the number of unvested options by a fraction the numerator of which represented the length of time the employee owned the options prior to dissolution of the marriage (that is, the length of time the employee owned the options during and prior to the marriage) and the denominator of which represented the time between the date the options were issued and the date on which they were scheduled to vest. The resulting product determined the number of shares subject to division among the divorcing parties.
In *Jones, supra*, the court included under its time rule an extra year beyond the normal time rule applied by California courts. Under the normal California time rule, when determining divorcing parties’ community property interests, the community is allocated a fraction of a spouse’s options, the numerator of which is the length of service during the marriage, but before separation, and the denominator of which is the total length of service by the employee-spouse. This ratio is then multiplied by the total number of options, to determine the community interest. The court, in applying this time rule, instead included in the denominator a year which followed termination of employment (and after separation of the parties), where the extra year was counted toward the vesting of options per a severance agreement the employee-spouse reached with her employer after the parties separated.

Stock options awarded the day after the entry of a divorce decree were not marital property subject to division among the divorcing spouses in *Clance v. Clance*, 127 S.W.3d 716 (Mo. Ct. App. 2004). The options were not marital property even though they were granted for work performed prior to entry of the divorce decree. That was because the employee had no enforceable right to the options until the day after the marriage was dissolved and the trial court therefore did not have jurisdiction to divide the options.

Stock options awarded three days before filing for divorce were not subject to equitable distribution, but were instead the property of the employee, where (a) the parties separated before the employee took the new job in connection with which the options were granted, (b) the options vested in one-fourth increments over the succeeding four years (so none would vest until almost 12 months after the divorce filing), and (c) the options were offered as an inducement to commence employment and not as a recognition of past performance during the time preceding the divorce filing. *Robertson v. Robertson*, 381 N.J. Super. 199, 885 A.2d 470 (Sup. Ct. N.J. 2005).

Under Washington’s community property scheme, when a spouse, during a marriage, exercises stock options having a mixed character as both separate and community property, deposits the proceeds of the exercise into a single account, and then disburse those proceeds into four different investment accounts, so that it is impossible to trace the residual amounts contained in the accounts to the options from whence they came, the proceeds in the investment accounts are, by law, entirely community property. *Shui v. Rose*, 125 P.3d 180 (Wash. Ct. App. 12/19/05).

**ERISA Issues**

**ERISA Claims**

Courts continue to conclude that stock option plans are not employee benefit plans subject to ERISA. *Oatway v. American Int’l Group, Inc.*, 325 F.3d 184, 30 EBC 1321 (3rd Cir. 2003) (in a matter apparently of first impression for the Third Circuit, the court held that a stock option plan was not an employee welfare benefit plan under ERISA); *Estate of McLoone v. Intel Corporation*, 1 Fed. Appx. 715, 2001 WL 32067 (9th Cir. 2001) (unpublished) (stock option plan not subject to ERISA; as a consequence, there could be no breach of ERISA fiduciary duty for failing to tell estate of its right to exercise deceased employee’s options despite estate’s repeated inquiry concerning benefits to which it was entitled); *Prieto v. Election.com*, 2005 WL 3560596
(E.D. N.Y. 2005) (stock options were not a welfare plan under ERISA; did not seem to address whether options could constitute a pension plan); Sanfeliz v. Chase Manhattan Bank, 349 F.Supp.2d 240, 34 EBC 2589 (D. P.R. 2004); Hoyos v. Telecorp Communications, Inc., 405 F.Supp.2d 199 (D. P.R. 2005).

For another decision in which stock options were held not to be pension plans subject to ERISA, see Adams v. Intralinks, Inc., 2004 WL 1627313, 33 EBC 1959 (S.D. N.Y. 2004), motion to vacate denied, 2005 WL 427878 (S.D. N.Y. 2005). In that case, stock options were granted under a stock incentive plan that the court concluded was a bonus plan within the meaning of 29 CFR § 2510.3-2(c), rather than an employee pension benefit plan under ERISA. It reached this conclusion because payments under the program were not “systematically deferred to the termination of covered employment or beyond,” nor made “so as to provide retirement income to employees,” since the terms of each option could not extend beyond 10 years from the date of grant and the options were subject to earlier termination upon the grantee's termination of employment.

Following its own decision in Oatway v. American International Group, Inc., 325 F.3d 184, 30 EBC 1321 (3d Cir. 2003), the Third Circuit held that a stock option plan was not subject to ERISA in Houston v. Aramark Corporation, 112 Fed. Appx. 132, 2004 WL 2203981, 33 EBC 2586 (3d Cir. 2004) (unpublished), cert. denied, 125 S. Ct. 2254, 34 EBC 2983 (2005). The court, as a consequence, rejected an ERISA claim for the payment of benefits under a stock option plan and a claim that the company breached its fiduciary duties under ERISA by failing to disclose to an executive a forthcoming initial public offering before the executive exercised his options.

A federal district court held that the opportunity to purchase stock in a holding company offered to selected employees as an incentive to increase the profitability of their employer was not a plan within the meaning of ERISA. Inman v. Klockner-Pentaplast of America, Inc., 467 F.Supp.2d 642, 39 EBC 2895 (W.D. Va. 2006).

A federal district court held that a phantom equity plan was not subject to ERISA even though the only in-service distributions permitted were those on account of a change of control. Bandy v. LG Industries, Inc. Equivalent Ownership Plan, 2003 WL 21499017, 30 EBC 2540 (E.D. Pa. 2003), subsequent determination, 2003 WL 22100876 (E.D. Pa. 2003) (attorneys’ fees issue). The plan permitted the payment of benefits only upon retirement, death, separation of employment, or change of control. The court relied on the Third Circuit’s analysis in Oatway, supra, in concluding that the plan was not an employee pension benefit under ERISA because it was not “created for the purpose of providing retirement income,” but was instead an incentive plan. The court’s analysis is notable because ERISA’s definition of an “employee pension benefit plan” does not make mention of the purpose of the program. ERISA instead provides that a program will be a pension plan subject to that Act if it “(a) provides retirement income to employees, or (b) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.” ERISA § 3(2)(A)(ii) (emphasis added)
A buy-sell agreement requiring the sale of stock on termination of employment, with that sale to occur at a specified price and with payment to be made over 60 months, was not subject to ERISA. *Roderick v. Mazzetti & Associates, Inc.*, 2004 WL 2554453, 34 EBC 1774 (N.D. Cal. 2004).

An individual deferred compensation arrangement was a plan under ERISA and, as a result, the participant’s state law claims were preempted in *Tilton v. Radiation Oncologists*, 409 F.Supp.2d 560, 37 EBC 2209 (D. Del. 2006). In determining whether the arrangement constituted a plan, the court applied the Third Circuit’s analysis in *Diebler v. United Food and Commercial Workers’ Local Union 23*, 973 F.2d 206, 209, 15 EBC 2442 (3d Cir. 1992) (which itself cited *Wickman v. Northwestern National Insurance Co.*, 908 F.2d 1077, 1083, 28 EBC 1071 (1st Cir. 1990), *cert. denied*, 498 U.S. 1013, (1990)). In particular, the court noted that the Third Circuit has emphasized that the “crucial factor in determining whether a ‘plan’ has been established is whether the employer has expressed an intention to provide benefits on a regular and long-term basis.” Further, a plan, fund or program under ERISA is established if, “from the surrounding circumstances a reasonable person can ascertain the intended benefits, a class of beneficiaries, the source of financing, and procedures for receiving benefits.”

A nonqualified deferred compensation plan was found to be an “excess benefit plan” within the meaning of Section 4(b) of ERISA, and therefore not subject to the provisions of ERISA, in *Isko v. Engelhard Corporation*, 367 F.Supp.2d 702, 34 EBC 2788 (D. N.J. 2005). As a result, an executive’s state law claims relating to plan benefits were not preempted by ERISA. The plan language which the court found to have established the program as an excess benefit plan read as follows:

> The purpose of the Excess Benefit Plan is to provide certain salaried employees with a pension benefit payable from employer funds, notwithstanding the limitations of Section 415 of the Internal Revenue Code as from time to time in effect (or of any similar provisions of the Code or any other law or regulations that may now or hereafter limit benefits payable under qualified pension or retirement plans (all of which are herein referred to as “Section 415 limitations”)), having an actuarial value equivalent to the excess of the amount of benefits which would have been payable to such employees under the Retirement Income Plan for Salaried Employees of [the company] (“Pension Plan”) were it not for the Section 415 limitations over the amount thereof in fact payable under the Pension Plan.

(Emphasis added)

The court in *Isko* held that the program was in fact an excess benefit plan, despite the parenthetical referring to “similar provisions of the Code or any other law or regulations.” The employer had argued (unsuccessfully) that this language suggested that the intended purpose of the plan was not solely to provide benefits in excess of the Section 415 limitations, but also to provide benefits in excess of the compensation dollar limitation imposed by Section 401(a)(17) of the Tax Code.
Severance plan benefits were provided under a plan subject to ERISA in *Kolkowski v. Goodrich Corp.*, 448 F.3d 843, 37 EBC 2249 (6th Cir. 2006). The severance plan, which provided for involuntary termination benefits upon a change of control, was subject to ERISA under a *Fort Halifax*-type analysis. The court noted that although it typically engages in a three-part test to determine whether a plan is subject to ERISA, as set forth in *Thompson v. American Home Assurance Co.*, 95 F.3d 429 (6th Cir. 1996), the court has generally looked at two particular factors in determining whether a severance agreement plan meets the *Fort Halifax* criteria. Those factors are (1) whether the employer has discretion over the distribution of benefits, and (2) whether there are on-going demands on the employer’s assets. As to the first of these, the determining characteristic for administrator discretion is whether the plan administrator makes individualized determinations of eligibility, as opposed to those that require automatic or simple decisions. The court concluded that the employer had discretion over the distribution of benefits because of the need to (1) make individualized decisions concerning whether the acquiring entity offered “comparable benefits” to those provided by the employer prior to the sale (if an employee were offered employment with the buyer with no reduction in base salary and benefits comparable to those prior to the change of control, the employee was not entitled to benefits), and (2) determine seniority status of each employee to calculate the amount of severance pay and the benefits due. The court also indicated that there were ongoing demands on the employer’s assets because although the plan provided for a one-time lump sum payment of salary and bonuses, certain benefits, such as medical, dental, and life insurance benefits, continued for a period after payment, and the plan covered involuntary terminations over a two year period following the change of control.

A federal district court concluded that payments to be made under an agreement entered into at termination of employment, which made reference to deferred compensation in the executive’s employment agreement in which the executive failed to vest, did not constitute a plan under ERISA. *Wayne v. Detroit Medical Center Nonqualified Deferred Compensation Plan*, 2007 WL 624124, 40 EBC 1342 (E.D. Mich. 2007). The court looked to guidance primarily from the decisions in *Kolkowski v. Goodrich Corp.*, 448 F.3d 843 (6th Cir. 2006); *Thompson v. American Home Assurance Co.*, 95 F.3d 429, 20 EBC 1857 (6th Cir. 1996); and *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 8 EBC 1729 (1987). The court noted that under *Fort Halifax* an arrangement is a plan under ERISA only if it establishes benefits requiring “an ongoing administrative program to meet the employer’s obligations.” The court observed that the Sixth Circuit in *Kolkowski* seemed to analyze whether a “severance agreement” plan falls under ERISA in a fashion different from its normal determination of whether a plan is subject to ERISA. Generally, in determining whether a plan is subject to ERISA, the Sixth Circuit’s decision in *Thompson* indicates that a court is to (1) determine whether the Department of Labor “safe harbor” regulations are applicable; (2) look to surrounding circumstances to determine whether a reasonable person could ascertain the intended benefits, the class of beneficiaries, the source of financing, and the procedures for receiving benefits; and (3) establish whether the employer has established or maintained a plan with the intent of providing benefits to its employees. In determining whether a severance agreement falls under ERISA, the Sixth Circuit in *Kolkowski* indicated that a court should look to (1) whether the employer has discretion over the distribution of benefits, and (2) whether there are ongoing demands on the employer’s assets. The district court concluded that the arrangement at issue involved a severance agreement, so it applied the *Kolkowski* analysis. The only condition to the former executive’s receipt of benefits was the satisfaction of the requirements of a covenant not to compete. The court concluded that
even if the employer’s discretion to determine whether that condition was met satisfied the first of the two prongs under the Kolkowski analysis, the benefit to which the former executive would be entitled was simply the payment of $750,000, so there would be no “ongoing benefits analysis” as necessary under the second Kolkowski prong for a severance agreement to be subject to ERISA.

A bonus was not considered to be an employee benefit plan under ERISA, even though recipients could voluntarily defer bonus amounts under a nonqualified plan. *Critelli v. Fidelity National Title Insurance Co. of New York*, 2007 WL 749693, 40 EBC 1311 (E.D. N.Y. 2007). The court said it is well established in the Second Circuit that a mere option to defer compensation is insufficient to trigger ERISA coverage, citing *International Paper Co. v. Sawyn*, 978 F.Supp. 506 (S.D. N.Y. 1997) and *Hahn v. National Westminster Bank*, 99 F.Supp. 2d 275 (E.D. N.Y. 2000).

A promise to pay pension benefits made at the time of employment did not create a plan under ERISA. *Guilbert v. Gardner*, 480 F.3d 140, 40 EBC 1297 (2d Cir. 2007). A former employee of a defunct business sued the business’ principals, asserting claims under ERISA and state law claims for breach of contract, promissory estoppel, and fraud. The plaintiff claimed he was promised pension benefits when he was hired and was repeatedly told throughout his employment that his pension benefits had been “taken care of.” The court concluded that no ERISA claims could stand because there was no evidence that a plan was “established” or “maintained.” *Citing Donovan v. Dillingham*, 688 F.2d 1367, 3 EBC 2122 (11th Cir. 1982), the court said the decision to provide benefits is not, by itself, enough to create a plan. Instead, acts or events that record, exemplify, or implement the decision to provide benefits are necessary for a plan to arise under ERISA. As to the state law claims, the former employee’s fraud claim was time-barred, but his contract claim (that defendants had agreed to make annual contributions to a pension arrangement) survived a statute of limitations challenge on a summary judgment motion.

A federal district court concluded that an employment agreement under which an employer promised to pay an additional $200,000 per year for several years, which the executive could choose to receive in cash or in benefits under a Section 457(f) plan, was not a plan under ERISA, even though the 457(f) plan was itself subject to ERISA. *Cooper v. Washington University*, 2006 WL 2092425, 38 EBC 2459 (E.D. Mo. 2006). The court concluded that there was no plan because there was no need for an ongoing administrative scheme within the meaning of the U.S. Supreme Court’s decision in *Fort Halifax Packing Co., Inc. v. Coyne*, 482 US 1 (1987). As a consequence of the plan not being subject to ERISA, the employer had no right to remove the lawsuit to federal court.

A federal district court concluded that a severance program promising one month’s salary for each year an employee worked for the employer ten years or longer was not a plan under ERISA. *Guccione v. Bell*, 2006 WL 2032641, 38 EBC 2135 (S.D. N.Y. 2006). The court concluded that the arrangement was not a plan by looking to the Second Circuit’s decision in *Kosakow v. New Rochelle Radiology Associates, P.C.*, 274 F.3d 706 (2d Cir. 2001), which in turn relied on the U.S. Supreme Court’s decision in *Fort Halifax Packaging Co. v. Coyne*, 482 U.S. 1 (1987). The court concluded that the severance program (which, again, paid terminated employees one month’s salary for every year the employee worked for the company ten years or longer) did not require “ongoing, particularized, administrative analysis of each case” and did
not give those who administered the program any discretion at all. The need to make the simple, one-time arithmetical calculation required to determine the amount due a severed employee and to pay that amount in a lump sum, did not require the kind of ongoing administrative scheme necessary for an arrangement to be a plan covered under ERISA.

The purchase for one executive of a single premium annuity providing benefits if the executive remained employed to age 65 did not create an employee benefit plan under ERISA. *Peace v. American General Life Insurance Co.*, 462 F.3d 437, 38 EBC 2101 (5th Cir. 2006). That was because there was no ongoing administrative scheme within the meaning of the Supreme Court’s *Fort Halifax* decision. As a result, the executive’s state law breach of contract claim was not preempted.

The terms of a deferred compensation plan were too sketchy to constitute a plan under ERISA in *Hughes v. White*, 467 F.Supp.2d 791, 40 EBC 2060 (S.D. Ohio 2006). In determining whether there was a plan under ERISA, the court applied the test developed by the Eleventh Circuit in *Donovan v. Dillingham*, 688 F.2d 1367, 3 EBC 2122 (11th Cir. 1982) (en banc). The *Dillingham* test was adopted by the Sixth Circuit in *Williams v. WCI Steel Co., Inc.*, 170 F.3d 598 (6th Cir. 1999). Under the *Dillingham* framework, a compensation scheme is governed by ERISA if a reasonable person examining the surrounding circumstances can ascertain: (1) the intended beneficiaries; (2) the class of beneficiaries; (3) the source of financing; and (4) the procedures for receiving benefits. As evidence of the existence of a plan, the plaintiff, who was a director and the corporate secretary, pointed to a board resolution which provided as follows:

Motion Carried: To Approve the Salary of [the director and corporate secretary) as an Employee at his Current Pay Level

The resolution was puzzling because the director was at the time the resolution was passed receiving no current salary. There was, however, some testimony that the intention was to accrue and defer the director’s salary for later payment. The court concluded there was no plan because of a failure to meet the fourth requirement under the *Dillingham* standards. That is, there were no discernable procedures for receiving benefits, and in particular there was no claims procedure which could be divined from the available evidence. In addition, there was a failure, at least for the first several years of the purported plan, to satisfy the first *Dillingham* requirement, the need to be able to ascertain the intended beneficiaries from the surrounding circumstances. This was true, in part, because as noted earlier the reference to the director’s “current pay level” was confusing since the director had not received any compensation to date, nor did he receive any during the next several years, although he had received a salary from an apparently unrelated employer.

A federal district court considered on a motion to dismiss whether an arrangement providing for the purchase of a stock index fund at a discount was a plan subject to ERISA. *Holzer v. Prudential Equity Group LLC*, 458 F.Supp.2d 587, 39 EBC 2450 (N.D. Ill. 2006). The court declined to hold at the motion to dismiss stage that the arrangement, which permitted participants to purchase with salary deferrals shares of the Prudential Stock Index Fund at a 25 percent discount, was not a plan subject to ERISA. An employee’s purchase of shares was subject to a three year restricted period. If a participant were to be terminated for cause or voluntarily terminated within three years, the participant would forfeit the shares purchased with
his or her salary deferrals. Although it appears that a participant could transfer shares after three years even if still employed, the court could not at the motion to dismiss stage say that the arrangement was not subject to ERISA because it appears the arrangement may have been promoted as a means to defer income to retirement, and because the arrangement was not clearly an incentive to encourage participants to continue their employment.


A plaintiff’s breach of contract claim against his employer for violating the terms of an employment agreement providing for benefits under a plan subject to ERISA was preempted. *Allocca v. Wachovia*, 2005 WL 2972845, 36 EBC 2274 (D. N.J. 2005).

[New Heading] **Complete Preemption: Quantum Meruit Claim Severance Benefits**

A former executive’s state law quantum meruit claim, alleging that her former employer was unjustly enriched by failing to pay severance benefits, was completely preempted. *Curcio v. Hartford Financial Services Group*, 469 F.Supp.2d 239, 40 EBC 2025 (D. Conn. 2007). As a result, the executive’s claim was removable to federal court. The court held that the claim was completely preempted under the Supreme Court’s guidance in *Aetna Health Inc. v. Davila*, 542 US 200, 32 EBC 2569 (2004), because (a) the executive could have brought her claim as an ERISA Section 502(a)(1)(B) claim for benefits, and (b) the employer’s alleged liability was derived from or dependent on the existence of the administration of an ERISA-regulated severance plan so that there was no legal duty independent of ERISA implicated by the employer’s actions.

[New Heading] **Fiduciary Breach: Reduction in Qualified Retirement Plan Benefits**

Where the president of a company breached his ERISA fiduciary duties by appointing family members as trustees of three qualified retirement plans and failing to monitor their performance, the president’s qualified retirement benefits were offset by the amount of the plan’s losses resulting from the breach. *Bennett v. Manufacturers & Traders*, 2005 WL 2896962, 36 EBC 1085 (N.D. N.Y. 2005). The son of the president had, as a trustee of the plans, dissipated plan assets by almost $2.7 million, to a large degree for the benefit of the company and related companies. The court’s opinion is not entirely clear whether this offset occurred under ERISA Section 206(d)(4), or whether instead the offset was permitted as a restitution remedy for a fiduciary breach. In particular, the court did not expressly discuss the anti-alienation issue addressed by ERISA Section 206(d)(4), although the opinion did include an oblique reference to the company’s bankruptcy trustee having amended the 401(k) plan to incorporate Section 206(d). The court then stated “such amendment thus permitted a direct setoff of plan benefits otherwise payable to a plan participant to recover losses to the plan by reason of a breach of fiduciary duty by such participant.” In fact, however, Section 206(d)(4) permits an offset only where a participant has been ordered or required to pay amounts to the plan under a criminal conviction, civil judgment for a fiduciary breach (or other violation of Part 4 of Title I of ERISA), or pursuant to a settlement agreement between the participant and the Secretary of Labor or Pension Benefit Guaranty Corporation. None of these circumstances seems to have been present.
Interlocking Statutory Issues

[New Heading] Bankruptcy of Employer: Priority for Executive Compensation

The First Circuit rejected an executive’s argument that her claim for the payment of termination benefits pursuant to her pre-petition employment and retention agreements was a first-priority administrative expense in her employer’s Chapter 11 proceeding. *In re FBI Distribution Corp.*, 330 F.3d 36, 30 EBC 1646 (1st Cir. 2003). The executive had been hired as president of a division several months before the company’s bankruptcy filing, and in accepting that job had left a high-paying position as president of an unrelated company. Prior to commencing employment, the parties signed two written agreements: an employment agreement and a retention agreement. Under the employment agreement, the executive was entitled to receive three years’ salary and other fringe benefits if she were terminated without cause. In addition, under the retention agreement the executive was entitled to three years’ salary plus other benefits if her employment were terminated following a qualifying “change in control.” Following the employer’s bankruptcy filing, the executive continued to provide services pursuant to her pre-petition employment agreement, for which she received her full salary and benefits owed during her employment.

The executive, in arguing for priority in the bankruptcy proceeding, claimed she was induced to remain with the company following the bankruptcy filing by the employer’s post-petition promise that her two agreements were “in effect and would be honored.” About six weeks later after this promise was allegedly made, the executive was notified that she was being put on “administrative leave,” with pay, pending the employer’s motion to reject both agreements. While that motion was under advisement, the employer sold substantially all its remaining assets to another corporation. The bankruptcy court then granted the employer’s motion to reject the executive’s employment agreement, but ruled that the retention agreement could not be rejected because it was nonexecutory since the executive had no performance obligations under the agreement. Four days after the court ruled, the executive’s employment was terminated.

The court noted that where a debtor-in-possession assumes an executory contract, the liabilities in performing that contract are treated as administrative expenses. In contrast, where a contract is rejected – as occurred with the employment agreement under consideration – the contract is deemed breached on the date “immediately before the date of the filing of the petition,” and the non-debtor party has a pre-petition general unsecured claim for breach of contract damages, which is not entitled to administrative priority. Where, however, the debtor-in-possession induces a non-debtor to render performance pursuant to an unassumed pre-petition executory contract pending its decision to reject or assume, the non-debtor party will be entitled to administrative priority to the extent the consideration supporting the claim was supplied to the debtor-in-possession during the reorganization and was beneficial to the estate. In this case, though, the court concluded that the consideration the executive provided for the employer’s promise of severance benefits under the employment agreement was her agreement to forego other employment opportunities, which she provided pre-petition the moment she signed the employment agreement. As a consequence, the executive’s claim was not entitled to priority even if the executive were induced to remain with the company post-petition.
The executive not only enjoyed no priority for severance benefits under the employment agreement, she was not even entitled to enforce the terms of the employment agreement as a general creditor because the agreement was rejected. Instead, where a debtor-in-possession, such as the executive’s employer elects to continue to receive services under an executory contract pending a decision to reject or assume that contract, the debtor-in-possession is obligated to pay only the reasonable value of the services provided post-petition. The court noted, however, that the executive’s employment agreement could be probative of the reasonable value of the executive’s services, although it would not be dispositive. As to the retention agreement, the parties had agreed it was a nonexecutory contract because the executive owed no performance under it. Again, however, the consideration supporting that agreement – to forego other employment opportunities – was supplied when the executive signed the agreement. So, while the claim under the retention agreement was enforceable against the bankruptcy estate, it was a pre-petition claim.

[New Heading] Bankruptcy of Employer: Sale of Assets as Change in Control

An executive was entitled to a payment of $5 million under a change in control provision of the executive’s employment agreement upon the sale of the company’s assets in bankruptcy. The executive’s employment agreement did not provide any exception for sales following bankruptcy, and therefore the agreed upon amounts were due the executive. Fix v. Quantum Industrial Partners LDC, 374 F.3d 549 (7th Cir. 2004).

[New Heading] Bankruptcy of Employer: Failure to Provide Notice of Termination, One-Year Limitation on Compensation

A federal district court concluded that high level executives’ claims against a bankrupt company’s estate were limited under Section 502(b)(7) of the Bankruptcy Code to one-year’s compensation. The executives claimed damages resulting from the failure of the bankrupt employer to provide the executives with 90-days’ notice prior to the termination of their employment, as required under the terms of their employment agreements. The court explained that Section 502(b)(7) draws a distinction between (1) claims for “unpaid compensation due under [a] contract, without acceleration” – that is, compensation already earned as of the termination date – and (2) claims for amounts that are accelerated or become due by virtue of termination. Claims that fall into the first category, if allowed, may be recovered in full, while the Bankruptcy Code caps the second category of claims at an amount equal to one-year’s compensation under the employment contract. This means, the court explained, that the one-year cap limits an employee’s claims for severance pay, because such a claim is, in effect, a claim for prospective compensation that is accelerated as a result of termination of employment. The one-year cap does not, however, apply to employee claims for earned but unpaid compensation, bonuses, or accrued and earned unused vacation time, as those are claims for “unpaid compensation due . . . without acceleration” – that is, claims for amounts already earned at the time of termination.

The court concluded that the plaintiffs’ claims for notice compensation were subject to the one-year cap because the claimed amounts were prospective compensation to be paid on termination of employment. This was compensation the executives would otherwise have earned in the future had the termination not occurred. It was not compensation for services already
rendered and thus was not “unpaid compensation due . . . without acceleration.” *In re Dornier Aviation (North America), Inc.*, 305 BR 650 (E.D. Va. 2004).

[New Heading] Bankruptcy of Employer: Recovery of Deferred Compensation Where Distribution was Accelerated

The bankruptcy court handling the Enron Corp. Chapter 11 petition approved a request by Enron and a related bankrupt affiliate (collectively, “Enron”) to authorize an offer to settle claims against recipients of accelerated deferred compensation distributions, and to bring suit against those recipients not settling. *In re Enron Corp.* (Bankr. S.D.N.Y. 9/22/03). The debtors, and the court-approved Creditors and Employment-Related Issues Committees, had agreed that at least a portion of the accelerated distributions should be recovered. According to the motion filed by Enron, participants in Enron’s nonqualified deferred compensation plans had the opportunity to defer a portion of their salaries, bonuses and long term incentive compensation, including restricted stock, performance unit cash, and gains derived from the exercise of stock options. The deferred amounts were payable from the plans to participants on retirement, death, disability, or termination of their employment not for “cause.” In addition, however, plan participants had a right to receive a benefit at any time, subject to forfeiture of 10 percent of the amount to be distributed and the suspension of participation in the plan for 36 months from the date of distribution.

During the approximately five weeks preceding the date Enron filed its petition under Chapter 11, approximately 206 participants requested accelerated distributions. Of those requests, 126 were approved, which resulted in the distribution of roughly $53 million in cash and $500,000 in Enron common stock. Enron, in its motion, indicated that it was not aware of any theory for recovering the stock portion of the accelerated distributions, whether that stock was subsequently sold for cash or held for investment. With respect to the cash portion of the distributions, Enron argued that although the accelerated distributions were made in accordance with the terms of the deferral plans, the accelerated distributions might be subject to avoidance in accordance with Bankruptcy Code §§ 544, 547, 548, 549, and/or 550. In addition, Enron argued that a portion of some of the recipients’ pre-petition salary or bonuses might be subject to challenge as a preference or fraudulent conveyance.

The court approved the requested authority to settle with recipients of the accelerated distributions, and to file suit against those not choosing to settle in accordance with the approved terms. Under the approved terms of settlement, recipients of accelerated distributions were placed into three categories:

1. Active employees (Group I);
2. Former employees whose employment was involuntarily terminated, other than for cause, following the date Enron filed its bankruptcy petition (Group II); and
3. Recipients who (a) were not employed as of the date Enron filed its bankruptcy petition, (b) who voluntarily terminated their employment with Enron, or (c) whose employment was involuntarily terminated for cause (Group III).

Under the approved settlement offer, Group I recipients would be required to repay 40 percent of the cash component of their accelerated payments. Group II recipients would be
required to repay a percentage of the cash component of their accelerated payments, with that percentage determined by their date of termination. The percentages required to be repaid ranged from 40 percent to 85 percent, with greater repayment required of those who remained employed post-petition for a shorter period of time. Group III recipients would be required to repay 90 percent of the cash portion of their accelerated distributions. The rationale for the differing treatment of the groups was to reward those who continued, post-petition, to provide value to Enron, or who had done so at least to some extent.

Bankruptcy of Employer: Eliminating Retiree Benefits

A company that filed for relief under Chapter 11 of the Bankruptcy Code could not avoid application of special rules restricting the elimination of retiree benefits by filing a motion to eliminate those benefits one day prior to terminating executives’ employment. The company argued that it could reject executory agreements to pay annual premiums of up to $7,000 for long term care insurance coverage for the lifetimes of the executives and their spouses, and to provide lifetime continuation of health insurance benefits, by filing a motion pursuant to Section 365 of the Bankruptcy Code one day prior to involuntarily terminating the executives. The court concluded that the company must instead comply with the provisions of Section 1114 of the Bankruptcy Code, which set forth a process for the modification of retiree benefits for “medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death, under any plan, fund or other program (through the purchase of insurance or otherwise) maintained or established in whole or in part” prior to the filing of the bankruptcy petition. Under the required process, after the filing of a company’s bankruptcy petition and before filing an application to modify retiree benefits, the trustee in bankruptcy must make a proposal to the authorized representative of the retirees, providing for those necessary modifications in the retiree benefits “that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably . . . .” The company argued, unsuccessfully, that the procedure specified in Section 1114 did not apply because the executives were not retired at the time the motion to eliminate benefits was filed. The court also concluded that the executives were to be considered retired by reason of their involuntary termination. General Datacomm Industries, Inc. v. Arcara, 309 BR 848, 32 EBC 1437 (D. Del. 2004), aff’d, 407 F.3d 616, 34 EBC 2642 (3d Cir. 2005).

On appeal, the Third Circuit affirmed the district court’s decision in General Datacomm, agreeing that the employees forced to retire were retirees under Bankruptcy Code Section 1114, and were therefore entitled to the protections set forth in that section with respect to the provision of health insurance, even though their employment was terminated after the bankruptcy filing. In reaching this conclusion, the court seemed to rely on the particular facts of the case: notably, all the terminated employees were over age 65, they were terminated just one day after the Section 365 motion was filed, and the employer intended in taking its actions to thwart the protections of Section 1114. Under these circumstances, the individuals were considered to be entitled to the protections of Section 1114. The obligation to provide the retiree benefits was, however, an executory contract under Section 365, so it might indeed be rejected if the employer were to follow the appropriate process under Section 1114. The contract was executory because the retirees still had material obligations under the arrangement, given that their benefits would cease if they violated noncompete, confidentiality, or certain other obligations. The court also
concluded that the employer had waived any argument that long-term care benefits were not benefits of the type covered under Section 1114.

[New Heading] Bankruptcy of Employer: Top Hat Plan

A deferred compensation program was determined to be a “top hat” plan, and the benefit claims of plan participants were general unsecured claims against the employer which had filed a voluntary petition under Chapter 11 of the Bankruptcy Code, in In re IT Group, Inc., 305 BR 402, 32 EBC 2906 (Bankr. D. Del. 2004), aff’d, 323 BR 578, 35 EBC 1413 (D. Del. 2005). The court rather easily concluded that the arrangement was unfunded, as necessary for the arrangement to constitute a top hat plan. The plan document included typical top hat language, indicating that the plan was unfunded and that payments were to be made from the general, unrestricted assets of the employer. A trust agreement establishing a rabbi trust was apparently executed, but the trust was not funded. The court noted that even if the rabbi trust had been funded, that would not have caused the arrangement to have been funded so as to cause the arrangement to lose top hat status.

The plaintiffs argued that one of them had been told by the company’s president and CEO that the plan was a funded arrangement and that in the event of the company’s insolvency the rabbi trust would be funded and the amounts owed to participants would be paid in full. The court held that parol evidence, such as oral representations, would not be admissible because the plan was unambiguous concerning its funded status (and the plan included an integration clause).

The plan participants also argued that the plan was not a top hat arrangement because it did not cover a select group of management or highly compensated employees. The court indicated that to constitute a “select group of management or highly compensated employees” the group of covered employees must meet both a “quantitative” and a “qualitative” standard. With respect to the quantitative “select group” requirement, the court asserted that, while not a bright-line test, the highest percentage of employees covered by a plan found to have been a “top hat” plan had been 15 percent, citing Demery v. Extebank Deferred Comp. Plan, 216 F.3d 283, 24 EBC 2095 (2d Cir. 2000). The plaintiffs submitted no proof that the quantitative requirement was not met. As to the qualitative requirement, the court said participants must all be “high-level” employees, which could be satisfied by being either “management” or “highly compensated” employees. The court concluded that each participant was, in fact, both a management level employee and highly compensated. The court rejected the plaintiffs’ argument that to be a management employee one must be an executive-level employee. Instead, the court found it adequate for the covered employees to be at the “manager” level or higher. As to compensation, the only employees eligible to participate in the plan were those with a base annual salary of at least $100,000 and who were eligible to participate in the company’s bonus incentive plan. The court determined that these standards made the employees “highly compensated” for top hat plan purposes.

The bankruptcy court’s decision was affirmed in Accardi v. IT Corp. (In re IT Group Inc.), 2005 WL 742879 (D. Del. 2005). In affirming the decision, the district court rejected the executives’ argument that (a) the plan committee had a duty of good faith and fair dealing to order funding of the plan when it appeared the debtor-employer was on the verge of insolvency, and (b) the court should therefore consider the plan funded (and not a top hat plan under which
the executives were general unsecured creditors of the employer). In reaching its conclusion, the
court noted that the rabbi trust’s express provisions made the trust assets subject to the
employer’s general creditors, and concluded that because the rabbi trust was the only trust
created under the plan, the only discretion afforded to the committee was to set aside monies in
that trust.

The plaintiffs then appealed from the district court decision on one issue – whether the
arrangement was unfunded. In re IT Group, Inc., 448 F.3d 661 (3d. Cir. 2006). The plaintiffs,
of course, argued that the arrangement was funded, so it was not a top-hat plan and they could
proceed with their claims under ERISA. The court’s analysis was very similar to that of the
bankruptcy court in its initial decision. In getting to the same conclusion as the bankruptcy
court, the Third Circuit surveyed cases decided by the Second, Fifth, and Eighth Circuit Courts
of Appeal concerning what constitutes an unfunded arrangement for purposes of determining
whether an arrangement was a top-hat plan exempt from ERISA’s funding and fiduciary
requirements. After doing so, the Third Circuit came to its own formulation for determining
whether an arrangement is unfunded, synthesizing principles from the other circuit courts of
appeal. The court stated its rule as follows:

We agree with our fellow courts of appeals that the keys to the determination of
whether a plan is “funded” or “unfunded” under ERISA are (1) whether
beneficiaries of the plan can look to a res separate from the general assets of the
corporation to satisfy their claims; (2) whether beneficiaries of the plan have a
legal right greater than that of general, unsecured creditors to the assets of the
corporation or to some specific subset of corporation assets. We may also
consider the plan’s intended and actual tax treatment.

448 F.3d at 669. The reference to the plan’s tax treatment appears to have been a reference to
the Fifth Circuit’s statement in Reliable Home Health Care, Inc. v. Union Central Insurance Co.,
295 F.3d 505, 514, that a “plan is more likely than not to be regarded as unfunded if the
beneficiaries under the plan do not incur tax liability during the year that the contributions to the
plan are made.” (Quoting Miller v. Heller, 915 F.Supp. 651, 659 (S.D. N.Y. 1996)).

Executives’ claims for payment of top hat plan benefits from an employer that was a
predecessor to the executives’ bankrupt employer was rejected in Bender v. Xcel Energy, Inc.,
2006 WL 1371658, 38 EBC 2604 (D. Minn. 2006). A bankruptcy court order had discharged the
executives’ ultimate employer from liability for the payment of benefits under the predecessor
employer’s nonqualified plan, but under the order the predecessor employer retained liability for
benefits attributable to service with the predecessor “to the extent [the predecessor employer] has
not previously satisfied such obligation.” The predecessor employer’s earlier transfer to the
bankrupt employer of cash equal to the deferred compensation balances in the plan at the time of
transfer was considered to satisfy the predecessor’s obligation. As a result, the executives’
claims were barred by the bankruptcy discharge order. Even if the claims had not been so
discharged, there was a plan provision providing that “[p]ayments shall be made only by the
Participating Employer which last employed the Participant before payments commenced.” The
court held that this would also preclude any recover against the predecessor employer.
Bankruptcy of Employer: Attempt to Reject Nonqualified Plan after Plan of Reorganization Confirmed

A company which reorganized under Chapter 11 of the Bankruptcy Code could not, after the company’s plan or reorganization had been confirmed, ask the Bankruptcy Court to allow it to reject supplemental retirement agreements, where the company had not previously filed a motion to reject those agreements and the plan of reorganization did not provide for the rejection of the agreements. In re Northwestern Corp., 324 BR 529, 35 EBC 1936 (Bankr. D. Del. 2005).

Bankruptcy of Participant: Inclusion of Stock Options in Bankruptcy Estate

Two courts have concluded that unvested stock options may become part of a participant’s bankruptcy estate, with each court applying a time rule to determine the portion of the unvested options to be included. DeNadai v. Preferred Capital Markets, Inc., 272 BR 21 (D. Mass. 2001) (time rule applied so as to include only those options relating to the debtor’s pre-petition efforts; no exemption was available under Sections 522(b)(2)(A) or 554(c)(2) of the Bankruptcy Code); Stoebner v. Wick (In re: Wick), 276 F.3d 412, 27 EBC 1366 (8th Cir. 2002) (pro rata portion of unvested option proceeds were property of bankruptcy estate; portion included was determined under time rule, where option proceeds were multiplied by a fraction, the numerator of which was the time (in this case, measured in months) from the date of grant to the filing of the bankruptcy petition, and the denominator of which was the full vesting period (measured in months)).

Employer’s Tax Deduction: Underreporting of Income by Executive

The United States Court of Appeals for the Federal Circuit concluded that the amount an employer is entitled to deduct under IRC Section 83(h) for nonstatutory stock option compensation is the value of the transferred property includible in the executive’s gross income, not any smaller amount that is actually reported by the executive as taxable or that the executive and the IRS ultimately agree should be included as taxable. Robinson v. United States, 335 F.3d 1365 (Fed. Cir. 2003), cert. denied, 540 U.S. 1105, 124 S. Ct. 1044 (2004). The executive in Robinson made a Section 83(b) election to include in income the bargain element of stock he purchased under the employer’s option program. The executive reported to the IRS that there was no bargain element in the exercise, representing that the $2 million he paid for the employer’s stock reflected the stock’s fair market value. The employer, in contrast, claimed that the stock purchased by the executive was, at the time of exercise, worth $28.8 million. The IRS, following an audit, valued the shares at roughly the same figure as that asserted by the employer, but argued – consistent with Treasury Regulation § 1.83-6(a) – that the employer was entitled to a deduction only for the amount actually reported by the executive on an original or amended return, or the amount included in the executive’s gross income as a result of an IRS audit. This was important because although the IRS had proposed to increase the executive’s gross income by an amount roughly equal to the amount of the deduction claimed by the employer, the IRS and executive had not yet reached final agreement as to the amount, if any, by which the executive’s gross income would be increased. Under the IRS’ position, the employer would not be entitled to a deduction until and unless that amount were determined. After reviewing the relevant legislative and regulatory history, the court rejected the Service’s argument, instead
allowing the employer a deduction equal to the bargain element includible in the executive’s income.

The holding in Robinson is directly contrary to the Tax Court’s earlier conclusion in Venture Funding Ltd. v. Commissioner, 110 TC 236 (1998), which was affirmed in 1999 by the Sixth Circuit in an unpublished decision. 198 F.3d 248 (Table), cert. denied, 530 US 1205, 120 S. Ct. 2201 (2000). In Venture Funding, the court concluded that the term “included,” as used in Section 83(h), meant the amount actually included in the taxable income of the recipient, not the amount “includible.” It is notable that the Robinson case was decided by the Federal Circuit, since all taxpayers have access to the Court of Federal Claims, the decisions of which are appealed to the Federal Circuit.

Litigation and Procedural Issues, Special

Discovery

Shareholders of a savings and loan stated a proper purpose for compelling disclosure of books and records relating to compensation of the S&L’s chief executive officer under Section 220 of the Delaware General Corporation Law (8 Del. C. § 220) where (a) an independent study of the CEO’s compensation commissioned by the shareholders concluded that the CEO’s compensation was in the 95th to 100th percentile of CEOs of S&Ls of similar size, (b) the CEO’s annual compensation amounted to approximately 10 percent of the market capitalization of the S&L, (c) the compensation was received for performing what appeared to be an unremarkable amount of work, primarily involving the oversight of litigation handled by outside counsel, and (d) the S&L had only two employees other than the CEO. Haywood v. Ambase Corp., 2005 WL 2130614, 36 EBC 2195 (Del. Ch. unpub. 2005). The stated purpose of the shareholders’ request to inspect the company’s books and records was to “investigate possible mismanagement, breaches of fiduciary duty, waste of corporate assets and fraud at [the company], to assess the independence or lack thereof of the non-management members of the board of directors of [the company], and to communicate with other stockholders about the results of such investigation.” The court found that the shareholders had demonstrated a credible basis to find probable wrongdoing.

In contrast, a stockholder was not, under Section 220 of the Delaware General Corporation Law, entitled to compel inspection of a corporation’s books and records relating to three senior executives’ compensation merely because the stockholder suspected that the executives’ compensation was excessive and wasteful, since the stockholder made no credible showing that members of the company’s board of directors had violated their duties of loyalty and care in approving the executives’ compensation, or committed waste or mismanagement in approving that compensation. Seinfeld v. Verizon Communications, Inc., 2005 WL 3272365, 37 EBC 1445 (Del. Ch. 2005) (unpublished), aff’d, 909 A.2d 117 (Del. 2006).

Waste/Fiduciary Breach

In what many view as an important case suggesting the possibility of increased scrutiny of directors’ executive compensation decisions, the Court of Chancery of Delaware denied a motion to dismiss claims against (a) board members of the Walt Disney Company alleging waste
and breaches of fiduciary duty, and (b) the company’s president for breach of his fiduciary duties by engaging in a self-interested transaction with a friend (the CEO). *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275, 30 EBC 2288 (Del. Ch. 2003). The decision related to the same set of facts considered by the Delaware Supreme Court in its decision in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). In *Brehm*, the court reversed a Court of Chancery decision granting the defendants’ earlier motion to dismiss, and remanded the case to the Court of Chancery to permit the plaintiffs to file an amended complaint.

The action was a shareholder derivative suit alleging that the members of the board of directors of The Walt Disney Company breached their fiduciary duties when they (a) “blindly approved” an employment agreement with Michael Ovitz as president of the company, and (b) later, without any review or deliberation, ignored the CEO’s dealings with the president regarding the president’s “non-fault” termination of employment.

The court held that the plaintiffs’ new complaint sufficiently plead, for purposes of withstanding a motion to dismiss, breaches of fiduciary duty by the board of directors in connection with hiring the president, and by a subsequent board of directors with respect to the president’s termination. In particular, the court held that the plaintiffs’ allegations gave rise to a cognizable question of whether the defendant-directors should be held personally liable to the corporation for a knowing or intentional lack of due care in their decision-making process regarding the president’s employment and termination.

The court’s decision is striking in its tone. The court said, in part:

> It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision-making by corporate directors. Quite the contrary; plaintiffs’ new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders. Allegations that Disney’s directors abdicated all responsibility to consider appropriately an action of material importance to the corporation puts directly in question whether the board’s decision-making processes were employed in a good faith effort to advance corporate interests. In short, the new complaint alleges facts implying that the Disney directors failed to “act in good faith and meet minimal proceduralist standards of attention.”

The court described the facts as follows:

According to the new complaint, Eisner unilaterally made the decision to hire Ovitz, even in the face of internal documents warning of potential adverse publicity and with three members of the board of directors initially objecting to the hiring when Eisner
first broached the idea in August 1995. No draft employment agreements were presented to the compensation committee or to the Disney board for review before the September 26, 1995 meetings. The compensation committee met for less than an hour on September 26, 1995, and spent most of its time on two other topics, including the compensation of director Russell for helping secure Ovitz’s employment. With respect to the employment agreement itself, the committee received only a summary of its terms and conditions. No questions were asked about the employment agreement. No time was taken to review the documents for approval. Instead, the committee approved the hiring of Ovitz and directed Eisner, Ovitz’s close friend, to carry out the negotiations with regard to certain still unresolved and significant details.

The Old Board met immediately after the committee did. Less than one and one-half pages of the fifteen pages of Old Board minutes were devoted to discussions of Ovitz’s hiring as Disney’s new president. Actually, most of that time appears to have been spent discussing compensation for director Russell. No presentations were made to the Old Board regarding the terms of the draft agreement. No questions were raised, at least so far as the minutes reflect. At the end of the meeting, the Old Board authorized Ovitz’s hiring as Disney’s president. No further review or approval of the employment agreement occurred. Throughout both meetings, no expert consultant was present to advise the compensation committee or the Old Board. Notably, the Old Board approved Ovitz’s hiring even though the employment agreement was still a “work in progress.” The Old Board simply passed off the details to Ovitz and his good friend, Eisner.

Negotiation over the remaining terms took place solely between Eisner, Ovitz, and attorneys representing Disney and Ovitz. The compensation committee met briefly in October to review the negotiations, but failed again to actually consider a draft of the agreement or to establish any guidelines to be used in the negotiations. The committee was apparently not otherwise involved in the negotiations. Negotiations with Eisner continued until mid-December, but Ovitz had already started serving as Disney’s president as of October 1, 1995.

Eisner and Ovitz reached a final agreement on December 12, 1995. They agreed to backdate the agreement, however, to October 1, 1995. The final employment agreement also differed substantially from the original draft, but evidently no further committee or board review of it ever occurred. The final version of Ovitz’s employment agreement was signed (according to the new
complaint) without any board input beyond the limited discussion on September 26, 1995.

From the outset, Ovitz performed poorly as Disney’s president. In short order, Ovitz wanted out, and, once again, his good friend Eisner came to the rescue, agreeing to Ovitz’s request for a non-fault termination. Disney’s board, however, was allegedly never consulted in this process. No board committee was ever consulted, nor were any experts consulted. Eisner and Litvack alone granted Ovitz’s non-fault termination, which became public on December 12, 1996. Again, Disney’s board did not appear to question this action, although affirmative board action seemed to be required. On December 27, 1996, Eisner and Litvack, without explanation, accelerated the effective date of the non-fault termination, from January 31, 1997, to December 27, 1996. Again, the board apparently took no action; no questions were asked as to why this was done.

Disney had lost several key executives in the months before Ovitz was hired. Moreover, the position of president is obviously important in a publicly owned corporation. But the Old Board and the compensation committee (it is alleged) each spent less than an hour reviewing Ovitz’s possible hiring. According to the new complaint, neither the Old Board nor the compensation committee reviewed the actual draft employment agreement. Nor did they evaluate the details of Ovitz’s salary or his severance provisions. No expert presented the board with details of the agreement, outlined the pros and cons of either the salary or non-fault termination provisions, or analyzed comparable industry standards for such agreements. Notwithstanding this alleged information vacuum, the Old Board and the compensation committee approved Ovitz’s hiring, appointed Eisner to negotiate with Ovitz directly in drafting the unresolved terms of his employment, never asked to review the final terms, and were never voluntarily provide those terms.

During the negotiation over the unresolved terms, the compensation committee was involved only once, at the very early stages in October 1995. The final agreement varied significantly from the draft agreement in the areas of both stock options and the terms of the non-fault termination. Neither the compensation committee nor the Old Board sought to review, nor did they review, the final agreement. In addition, both the Old Board and the committee failed to meet in order to evaluate the final agreement before it became binding on Disney. To repeat, no expert was retained to advise the Old Board, the committee, or Eisner during the negotiation process.
The new complaint, fairly read, also charges the New Board with a similar ostrich-like approach regarding Ovitz’s non-fault termination. Eisner and Litvack granted Ovitz a non-fault termination on December 12, 1996, and the news became public that day. Although formal board approval appeared necessary for a non-fault termination, the new complaint alleges that no New Board member even asked for a meeting to discuss Eisner’s and Litvack’s decision. On December 27, 1996, when Eisner and Litvack accelerated Ovitz’s non-fault termination by over a month, with a payout of more than $38 million in cash, together with the three million “A” stock options, the board again failed to do anything. Instead, it appears from the new complaint that the New Board played no role in Eisner’s agreement to award Ovitz more than $38 million in cash and the three million “A” stock options, all for leaving a job that Ovitz had allegedly proven incapable of performing.

The New Board apparently never sought to negotiate with Ovitz regarding his departure. Nor, apparently, did it consider whether to seek a termination based on fault. During the fifteen-day period between announcement of Ovitz’s termination and its effective date, the New Board allegedly chose to remain invisible in the process. The new complaint alleges that the New Board: (1) failed to ask why it had not been informed; (2) failed to inquire about the conditions and terms of the agreement; and (3) failed even to attempt to stop or delay the termination until more information could be collected. If the board had taken the time or effort to review these or other options, perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision. In this case, however, the new complaint asserts that the New Board directors refused to explore any alternatives, and refused to even attempt to evaluate the implications of the non-fault termination—blindly allowing Eisner to hand over to his personal friend, Ovitz, more than $38 million in cash and the three million “A” stock options.

These facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a “we don’t care about the risks” attitude concerning a material corporate decisions. Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct, in my opinion, that may not have been taken honestly and in good faith to advance the best interests of the company. Put differently,
all of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss. Viewed in this light, plaintiffs’ new complaint sufficiently alleges a breach of the directors’ obligation to act honestly and in good faith in the corporation’s best interests for a Court to conclude, if the facts are true, that the defendant directors’ conduct fell outside the protection of the business judgment rule.

Of course, the alleged facts need only give rise to a reason to doubt business judgment protection, not “a judicial finding that the directors’ actions are not protected by the business judgment rule.” For this reason, I conclude that plaintiffs have satisfied the second prong of Aronson, and that demand is excused.

I also conclude that plaintiffs’ pleading is sufficient to withstand a motion to dismiss under Rule 12(b)(6). Specifically, plaintiffs’ claims are based on an alleged knowing and deliberate indifference to a potential risk of harm to the corporation. Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are either “not in good faith” or “involve intentional misconduct.” Thus, plaintiffs’ allegations support claims that fall outside the liability waiver provided under Disney’s certificate of incorporation.

The primary issue before the court was whether the complaint would survive a motion to dismiss, under the second prong in Aronson v. Lewis, 473 A.2d 805 (Del. 1984). The Aronson decision addressed shareholders’ need to make demand on a company’s board of directors before filing a derivative suit. For demand to be excused under the second prong of Aronson, the plaintiffs must allege particularized facts that raise doubt concerning whether the challenged transaction is entitled to protection under the business judgment rule. Plaintiffs may rebut the presumption that a board’s decision is entitled to deference by raising a reason to doubt whether the board’s action was taken on an informed basis or whether the directors honestly and in good faith believed that the action was in the best interest of the corporation. Therefore, to avoid the need to make demand on the board, the plaintiffs needed to plead particularized facts sufficiently to raise (1) a reason to doubt that the questioned action was taken honestly and in good faith, or (2) a reason to doubt that the board was adequately informed in making its decision.

The defendants argued that the complaint could not reasonably be read to allege any fiduciary duty violation other than, at most, a breach of the directors’ duty of due care. They argued that even if the complaint did state a breach of the directors’ duty of care, Disney’s charter included a provision, based on 8 Del. C. § 102(b)(7), that would protect the individual directors from personal damage liability for any such breach. The cited charter provision could not, however, under the Delaware statute “eliminate or limit the liability of a director: . . . (ii) for
acts or omissions not in good faith . . ..” The court concluded that a fair reading of the complaint gave rise to a reason to doubt whether the board’s actions were taken honestly and in good faith, as required under the second prong of Aronson, and as would be required to give effect to the exculpatory Disney charter provision.

The court went on to discuss the plaintiffs’ claim that the president himself breached his fiduciary duties by engaging in a self-interested transaction with his friend, the CEO. Although the court acknowledged that an officer may negotiate his or her own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner, neither the negotiation of the president’s employment terms following his hiring, nor the negotiation of the non-fault termination were arms-length. Instead, they were worked out with the president’s friend of 25 years, the CEO, and, accepting the facts alleged in the complaint, suggested that the president may have breached his fiduciary duties by engaging in a self-interested transaction in negotiating directly with his personal friend.

The court later had the opportunity to rule on the substance of the allegations in In re Walt Disney Co. Derivative Litigation, 2005 WL 2056651, 35 EBC 1705 (Del. Ch. 2005). In its decision on the merits, the court concluded that no party breached any fiduciary duty in connection with the hiring or termination of Michael Ovitz, the company’s president. In particular, Mr. Ovitz did not breach his duty of loyalty to the company because he was not involved in the decision to terminate him nor the decision to designate his termination as not for cause (which entitled him to substantial additional compensation). Nor did the CEO (Michael Eisner), the company’s general counsel, or board members breach their fiduciary duties or commit waste in the process of hiring or firing Mr. Ovitz. Although the court, in its exhaustive opinion, made clear its view that the company’s process had been less than ideal, no breach of duty had occurred. As part of its analysis, the court engaged in a careful discussion of the fiduciary duties owed by directors of a Delaware corporation. In particular, the court discussed the duties of due care and loyalty, and the possibility that there may be a third fiduciary duty, that of good faith. It also discussed (a) the business judgment rule, which the court described as a presumption that “in making a business decision the directors of a corporation acted on an informed basis, . . . and in the honest belief that the action taken was in the best interest of the company [and its shareholders]” (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), (b) the trend in recent Delaware cases toward examining breaches of fiduciary duty on a director-by-director basis, rather than looking at the board of directors as a whole, (c) the difficult standard for establishing corporate waste, and (d) the protection offered under Section 102(b)(7) of the Delaware General Corporation Law (8 Del. C. § 102(b)(7)) when a corporation includes in its certificate of incorporation protection from personal liability for directors who breach their duty of care (though such a provision offers no protection from injunctive relief for violation of that duty).

The plaintiff-shareholders failed to rebut the business judgment presumption because they failed to show that board members had either violated one of their fiduciary duties, or had failed to exercise business judgment (if they had failed to exercise business judgment, the standard for determining liability would likely have been gross negligence). The court emphasized that in determining whether there is a breach of the duty of due care, the focus is more on the quality of the decisionmaking process than on the quality of the decision that results.
The court also noted that duty of care violations are rarely found because they are actionable only if a director acts with gross negligence, and in most instances even if a duty of care violation can be proved, no money damages are available to the plaintiff. The court said that in the duty of care context, gross negligence has been defined as a “reckless indifference to or a deliberate disregard of the whole body of stockholders’ or actions which are ‘without the bounds of reason.’”

With respect to exculpatory provisions such as that authorized by Section 102(b)(7), the court said such a provision is in the nature of an affirmative defense. As a result, it is the burden of director defendants to demonstrate that they are entitled to the protections of the relevant charter provision.

The court focused most of its analysis on the fiduciary duty of due care and, to the extent it is separate and apart from the duties of loyalty and due care, the duty to act in good faith. The court did not seem to feel the need to resolve whether there is, in fact, a third duty – that of good faith – or whether that obligation instead emanates from the duties of due care and loyalty.

The only issue the court was required to address with respect to the traditional duty of loyalty (aside from whether there is an overlap between loyalty and good faith) was whether the terminated president, Mr. Ovitz, breached his fiduciary duty of loyalty in the course of his termination. As noted earlier, the court concluded that he did not do so because he was not involved in the questioned decisions.

As to any duty to act in good faith, the court concluded:

[T]he concept of the intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

The court went on to explain:

To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation. The presumption of the business judgment rule creates a presumption that a director acted in good faith. In order to overcome that presumption, a plaintiff must prove an act of bad faith by a preponderance of the evidence.

*   *   *   *   *

Fundamentally, the duties traditionally analyzed as belonging to corporate fiduciaries, loyalty and care, are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary.

*   *   *   *   *
A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscience disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

2005 WL 2056651 at *36 (footnotes omitted).

The court summarized the requirements for the plaintiffs to prevail in the following way:

[I]n the area of director action, plaintiffs must prove by a preponderance of the evidence that the presumption of the business judgment rule does not apply either because the directors breached their fiduciary duties, acted in bad faith or that the directors made an “unintelligent or unadvised judgment,” by failing to inform themselves of all material information reasonably available to them before making a business decision.

If plaintiffs cannot rebut the presumption of the business judgment rule, the defendants will prevail. If plaintiffs succeed in rebutting the presumption of the business judgment rule, the burden then shifts to the defendants to prove by a preponderance of the evidence that the challenged transactions were entirely fair to the corporation.

2005 WL 2056651 at *36-37 (footnotes omitted).

The court disposed of the waste claim because the company was better off without Ovitz, and his termination was, in fact, not for cause, which meant he was contractually entitled to the benefits paid to them.

As to the various claims concerning fiduciary breaches in connection with the decision to hire Ovitz and the negotiation of his agreement, the court concluded that the defendants did not act in bad faith, and were at most ordinarily negligent. In accordance with the business judgment rule (which the court applied business judgment was exercised), ordinary negligence was insufficient to constitute a violation of the fiduciary duty of care.

In connection with Michael Eisner’s actions relating to the hiring of Ovitz, the court had the following to say:

Despite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner’s actions were taken in good faith. That is, Eisner’s actions were taken with the subjective belief that those actions were in the best interests of the Company – he believed that his taking charge and acting swiftly and decisively to hire Ovitz would serve the best interests of the Company notwithstanding the high cost of Ovitz’s hiring and notwithstanding that two
experienced executives who had arguably been passed over for the position (Litvack and Bollenbach) were not completely supportive. Those actions do not represent a knowing violation of law or evidence a conscious and intentional disregard of duty. In conclusion, Eisner acted in good faith and did not breach his fiduciary duty of care because he was not grossly negligent.

2005 WL 2056651 at *41 (footnotes omitted).

Similarly, with respect to the compensation committee’s role in establishing and approving Ovitz’s compensation, the court said:

Viewed objectively, the compensation committee was asked to make a decision knowing that: 1) Ovitz was a third party with whom Russell negotiated at arms’ length; 2) regardless of whether Ovitz truly was “the most powerful man in Hollywood,” he was a highly-regarded industry figure; 3) Ovitz was widely believed to possess skills and experience that would be very valuable to the Company, especially in light of the CapCities/ABC acquisition, Wells’ death, and Eisner’s medical problems; 4) in order to accept the Company’s president, Ovitz was leaving and giving up his very successful business, which would lead a reasonable person to believe that he would likely be highly successful in similar pursuits elsewhere in the industry; 5) the CEO and others in senior management were supporting the hiring; and 6) the potential compensation was not economically material to the Company.

2005 WL 2056651 at *46 (footnotes omitted).

As to the termination of Ovitz, the court found unpersuasive the argument that the board members’ actions were in breach of their fiduciary duties because although the board had a right to remove officers of the company, that right was not exclusive to the board and the board therefore had no obligation to remove officers. In particular, the chairman/CEO Michael Eisner had the power, on his own, to terminate the president. And the compensation paid Mr. Ovitz upon termination had been established in connection with Mr. Ovitz’s original employment agreement, so the payment of those amounts did not require board action.

Finally, as to whether Mr. Eisner acted in accordance with his fiduciary duties and in good faith when he terminated Ovitz, the court concluded that he did. The court summarized by saying:

After reflection on the more than ample record in this case, I conclude that Eisner’s actions in connection with the termination are, for the most part, consistent with what is expected of a faithful fiduciary. Eisner unexpectedly found himself confronted with a situation that did not have an easy solution. He weighed the alternatives, received advise from counsel and then exercised his business judgment in the manner he thought best for the corporation Eisner knew all the material information reasonably available when making the decision, he did not neglect an affirmative duty to act (or fail to cause the board to act) and he acted in what he believed were the best interests of the Company, taking into
account the cost to the Company of the decision and the potential alternatives. Eisner was not personally interested in the transaction in any way that would make him incapable of exercising business judgment, and I conclude that plaintiffs have not demonstrated by a preponderance of the evidence that Eisner breached his fiduciary duties or acted in bad faith in connection with Ovitz’s termination and receipt of the NFT.

The Supreme Court of Delaware affirmed the Chancery Court’s decision in *In re Walt Disney Co. Derivative Litigation*, 2006 WL 1562466 (Del. 2006). Perhaps the most notable portion of the Delaware Supreme Court’s decision is its discussion of the Chancery Court’s articulation of the standard for bad faith corporate fiduciary conduct causing directors to lose the protection of the business judgment rule presumptions. Recall that the Court of Chancery had offered the following standard for determining bad faith conduct:

> [T]he concept of intentional dereliction of duty, a conscious disregard for one’s responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

The Supreme Court ultimately concluded that the Court of Chancery’s definition was a legally appropriate, although not the exclusive, definition of fiduciary bad faith. The court offered a lengthy and helpful discussion of what constitutes bad faith corporate fiduciary conduct. In upholding the Court of Chancery’s decision, the Supreme Court noted that the Chancery Court characterized the standard for bad faith it articulated (intentional dereliction of duty, a conscious disregard for one’s responsibilities) as being “an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith.” (Emphasis added) The Supreme Court held that the lower court’s conclusion that this was a standard for determining good faith, but not the only standard, was “accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the ‘bad faith’ pejorative label.” The court then discussed the three potential categories of bad faith fiduciary behavior. The first is subjective bad faith (motivated by actual intent to do harm). The court characterized this as constituting “classic, quintessential bad faith.”

The second category of conduct, which the court characterized as being at the opposite end of the spectrum, involves a lack of due care – that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent. The court concluded that grossly negligent conduct, without more, does not and cannot constitute a breach of fiduciary duty to act in good faith. In supporting its conclusion that gross negligence by itself is not bad faith, the court referred to two sections of Delaware statutory law. The court first noted that the Delaware General Assembly has addressed the distinction between bad faith and a failure to exercise due care (that is, gross negligence) in Section 102(b)(7) of the Delaware General Corporation Law (“DGCL”). That section authorizes Delaware corporations, by a provision in their certificates of incorporation, to exculpate their directors from monetary damage liability for breaches of the duty of care. The statute carves out several exceptions, however, from the behavior that may be exculpated, including most relevantly “acts or omissions not in good faith . . . .” The court said this means a corporation can exculpate its directors from monetary liability for a breach of the
duty of due care, but not for conduct that is not in good faith. The court concluded, then, that to adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission “not in good faith” would eviscerate the protections accorded to directors by the General Assembly’s adoption of Section 102(b)(7).

The second legislative recognition of a distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith is Delaware’s indemnification statute, found at 8 Del. C. § 145. In general, subsections (a) and (b) of that provision permit a corporation to indemnify directors, officers, employees, and agents against certain liabilities where the person “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation . . . .” Again, this showed the Supreme Court that Delaware statutory law permitted indemnification for liability (and litigation expenses) of a director or officer incurred by reason of a violation of the duty of care, but not for a violation of a duty to act in good faith.

The third potential category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent, and (2) conduct resulting from gross negligence, is what the Court of Chancery’s definition of bad faith – intentional dereliction of duty, and conscious disregard for one’s responsibilities – is intended to capture. The court agreed with the Chancery Court’s conclusion that such misconduct is properly treated as a non-exculpable, nonindemnifiable violation of fiduciary duty to act in good faith. In particular, where fiduciary conduct does not involve conflicting self-interest or disloyalty, but is qualitatively more culpable than gross negligence, the conduct should be proscribed. For this reason, the court upheld the Chancery Court’s definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith.

[New Heading] *Fiduciary Breach: Stock Option Backdating and Spring-Loaded Options*

In 2007, the Delaware Court of Chancery issued its first rulings in connection with the stock option backdating and spring-loading allegations that began circulating in the press in 2006. The first of the option backdating cases is *Ryan v. Gifford*, 2007 WL 1018208 (Del. Ch. 2007). *Ryan* involved allegations of backdating involving the stock of Maxim Integrated Products, Inc. In a shareholder derivative action, the complaint alleged that members of the company’s board of directors and compensation committee breached their duties of due care and loyalty by approving or accepting backdated options that violated the clear letter of two shareholder-approved stock option plans. Those plans required that the exercise price of all stock options granted be no less than the fair market value of the company’s common stock on the date of grant.

The court considered defendants’ motions to dismiss the action or, alternatively, to stay it in favor of earlier filed federal actions in California. The court refused to stay the action. Although it noted a general policy in favor of staying an action where there is a prior action pending elsewhere, the court denied the stay because of the novel and substantial issues of Delaware corporate law at stake, stating that Delaware has an overwhelming interest in resolving questions of first impression under Delaware law. The court noted that there have already been a number of securities fraud class actions and shareholder derivative class actions filed which challenge the timing of stock option grants, and suggested that there are likely to be many more...
filed in the coming months and years. The court said the allegations involving backdating option grants, and whether that practice violates one or more of Delaware’s common law fiduciary duties, is a question of great import to the law of corporations. It noted that this question encompasses numerous issues, including the propriety of this type of executive compensation, the requisite disclosures that must accompany such compensation, and the legal implications of intentional noncompliance with shareholder-approved plans (if such practices are deemed noncompliant). The court observed that investors are challenging the questionable practice in many courts throughout the United States, including the Court of Chancery of Delaware, and that Delaware courts have not yet addressed these fundamental issues even though Delaware law directly controls and affects many of the option backdating cases. Ominously to potential defendants in those cases, the court observed that “[a]n answer regarding the legality of these practices pursuant to Delaware law plainly will affect not only the parties to this action, but also parties in other civil and criminal proceedings where Delaware law controls or applies.” (Emphasis added.) The court noted that “[b]y directly stating the fiduciary principles applicable in this context, Delaware courts may remove doubt regarding Delaware law and avoid inconsistencies that might arise in the event other state or federal courts, in applying Delaware law, reach different conclusions.”

The court went on to address the defendants’ assertion that the plaintiffs failed to make demand or prove the futility of making demand. The court noted that when a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that the shareholder first make demand on the corporation’s board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation. This is to avoid “a myriad of individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation, which may tie up the corporation’s governors in constant litigation and diminish the board’s authority to govern the affairs the corporation.” (Quoting Sanders v. Wang, 999 WL 1044880 (Del. Ch. 1999).) Where, however, making demand would prove futile, demand upon the board is excused. In particular, failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent, or (2) the challenged acts were the product of the board’s valid exercise of business judgment. (Citing Aronson v. Lewis, 473 A.2d 805 (Del. 1984).) The analysis has a more subtle application where the board in place at the time the complaint is filed is different from the board that made the challenged decision. In that event – where the challenged transaction was not a decision of the board upon which the plaintiff must seek demand – the plaintiff must “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” (Emphasis added.) The court held that in the current case this more refined rule did not apply. Instead, the two Aronson grounds for excusing demand, noted earlier, would apply. That is because the company’s board of directors comprised six members, three of whom also comprised the members of the compensation committee. Notably, at the time the complaint was filed, the three members of the compensation committee who had made decisions relating to the challenged transactions remained members of that committee, as well as members of the board of directors. As a result, one-half of the current board members approved each of the challenged transactions. The court held that where at least one-half or more of the board in place at the time the complaint is filed approved the underlying challenged transactions (which approval may be imputed to the
entire board for purposes of proving demand futility), the Aronson test applies, under which demand is excused if either of the conditions in (1) or (2) above is established.

Although demand is excused where either of the two Aronson grounds is established, the court held that, in fact, both of those grounds for excusing demand were satisfied. First, demand would be futile under the second prong of Aronson, under which a plaintiff may prove demand futility by raising a reasonable doubt about whether the challenged transactions were a valid exercise of business judgment. The plaintiff’s allegations did raise a reason to doubt whether the option grants were a valid exercise of business judgment. In that regard, the plaintiff stated that the terms of the stock option plans required that the exercise price be not less than 100 percent of the fair market value of the stock on the date the option is granted. The board, therefore, was alleged to have no discretion to contravene the terms of the stock option plans. Altering the actual date of the grant so as to affect the exercise price would, therefore, contravene the plan. The court held that the unusual facts alleged did raise a reason to doubt that the challenged transactions resulted from a valid exercise of business judgment. In particular, it concluded that a board’s knowing and intentional decision to exceed the shareholders’ grant of express (but limited) authority raises doubt regarding whether that decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand. As to the unusual facts, the court observed that every challenged option grant allegedly occurred during the lowest market price of the month or year in which it was granted. In addition to pointing specifically to this “highly suspicious timing,” the plaintiff further supported his allegations with empirical evidence suggesting that backdating occurred, relying in particular on a Merrill Lynch analysis, which measured the extent to which stock price performance subsequent to options pricing events diverged from stock price performance over a longer period of time, to measure the aggressiveness of the timing of option grants. The Merrill Lynch analysis was released in early 2006 and involved an examination of the timing of stock option grants from 1997 to 2002 for the semiconductor and semiconductor equipment companies that comprised the Philadelphia Semiconductor Index. Although Merrill Lynch failed to take a position on whether Maxim actually backdated, it noted that if backdating did not occur, management of Maxim was remarkably effective at timing options pricing events. In particular, with regard to Maxim, Merrill Lynch found that the 20 day return on option grants to management averaged 14 percent over the five year period, an annualized return of 243 percent, or almost 10 times higher than the 29 percent annualized market returns in the same period. The court stated that “[t]his timing, by my judgment and by supporting empirical data, seems too fortuitous to be mere coincidence. The appearance of impropriety grows even more when one considers the fact that the board granted options, not at set or designated times, but by a sporadic method.”

Although demand is excused if either of the Aronson prongs is satisfied, and the court indicated that the second prong, concerning whether the challenged acts were the product of the board’s valid exercise of business judgment had been satisfied, the court went on to explain that the first prong, under which a question is raised about the board’s disinterestedness or independence, was also satisfied. In that regard, the court noted that directors who are sued have a disabbling interest for pre-suit demand purposes when “the potential for liability is not a mere threat but instead may rise to a substantial likelihood.” (Quoting In re Baxter International, Inc. Shareholders Litigation, 654 A.2d 1268 (Del. Ch. 1995).) The court, in tough language which may signal difficulties ahead for the defendants, stated that:
A director who approves the backdating of options faces at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty. Backdating options qualifies as one of those “rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.” Plaintiff alleges that three members of a board approved backdating options, and another board member accepted them. These are sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering demand. (Citations omitted.)

Adding fuel to the fire, the court added in a footnote:

Nor do defendant directors’ concerns necessarily end with consideration of the duty of loyalty. Were the board to pursue a derivative suit, it might unearth facts that would subject directors to further civil and criminal liability. Four board members, Gifford, Bergman, Wazzan, and Hagopian were familiar with Maxim’s stock option plans. In 1999, they recommended the most recent options plan and submitted it for shareholder approval accompanied by their own directorial stamps of approval. In 2000 and 2001 proxy statements filed pursuant to section 14(a) of the Securities Exchange Act of 1934, Bergman, Wazzan, and Hagopian, representing half of the board, verified that they bore direct responsibility for granting options and that they granted all options according to the options plan.

* * * * *

Further, Bergman, Wazzan, and Hagopian were also members of the audit committee, and as such, directly responsible for approving any false financial statements that resulted from mischaracterization of these option grants. Thus, they might be exposed to potential criminal liability for securities fraud, tax fraud, and mail and wire fraud.

After disposing of the defendants’ claim that the plaintiff was required to make demand upon the board, the court turned to the defendants’ assertion that the plaintiff failed to state a claim for breach of fiduciary duty because the complaint failed to rebut the business judgment rule. In other words, the defendants argued that the plaintiff failed to raise a reason to doubt that the directors were disinterested or independent. This is important because where the complaint does not rebut the business judgment rule, the plaintiff must allege waste. The court said that the same facts that established demand futility under the second prong of Aronson – that is, the director’s purposeful failure to honor an unambiguous provision of a shareholder-approved stock option plan – also rebutted the business judgment rule for the purpose of the motion to dismiss for failure to state a claim on which relief can be granted. Even were that not the case, the court noted that the complaint alleged bad faith and, therefore, a breach of the duty of loyalty sufficient to rebut the business judgment rule and survive a motion to dismiss. The court said that a showing that the board breached either its fiduciary duty of due care or its fiduciary duty of
loyalty in connection with a challenged transaction may rebut the presumption, and such a breach may be shown where the board acts intentionally, in bad faith, or for personal gain. In this regard, the court concluded it was “convinced that the intentional violation of a shareholder-approved stock option plan, coupled with fraudulent disclosures regarding the directors’ purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith.” Expanding on this, the court stated as follows:

I am unable to fathom a situation where the deliberate violation of a shareholder-approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.

In a footnote, the opinion expanded on this by stating that:

Plaintiff may survive a motion to dismiss where the complaint relies on empirical data to support claims of: 1) specific instances of backdating; 2) violations of shareholder-approved plans or some other legal obligation; and 3) fraudulent disclosures regarding compliance with the plan.

The court moved on to consider whether the three year statute of limitations for equity claims barred plaintiff’s action. The defendants asserted that the plaintiff could not save his claims by relying on any tolling doctrines since the relevant information was publicly available. The plaintiff conceded that he was relying on the Merrill Lynch report as the basis of his claims, and that report was prepared using publicly disclosed information and historical stock prices from the period 1997 to 2002. The court noted, however, that the plaintiff may toll the limitations period by specifically alleging that the facts were “so hidden that a reasonable plaintiff could not have made timely discovery of an injury necessary to file a complaint.” (Citing Smith v. McGee, 2006 WL 3000363 (Del. Ch. 2006).) Even if the plaintiff sufficiently meets his burden of showing that the statute was tolled, relief from the running of the statute extends only until the plaintiff is on inquiry notice. That is to say, tolling ends when the plaintiff discovers, or in the exercise of reasonable diligence should have discovered, his injury.

The plaintiff argued that the doctrine of fraudulent concealment tolled the statute of limitations. Fraudulent concealment “requires an affirmative act of concealment by a defendant – and “actual artifice” that prevents a plaintiff from gaining knowledge of the facts or some misrepresentation that is intended to put a plaintiff off the trail of inquiry.” (Citing In re Dean Witter Partnership Litigation, 1998 WL 442456 (Del. Ch. 1998).) The court concluded that the allegations in the complaint satisfied the requirements of the doctrine of fraudulent concealment. The defendants allegedly caused Maxim to falsely represent that the exercise price of all the stock options it granted pursuant to its stock option plans was no less than the fair market value of Maxim’s common stock, measured by the publicly traded closing price for Maxim stock on the date of the grant. To the extent the date on which the grant was issued was not the same as the date that the defendants, in public filings, represented that the grant was issued, the defendants affirmatively acted to conceal a fact that prevented plaintiff from gaining material
relevant knowledge in an attempt to put plaintiff off the trail of inquiry. In that regard, the plaintiff may rely on public filings and accept them as true, and need not assume that directors and officers will falsify such filings. Accordingly, where the plaintiff alleges that the defendants intentionally falsified public disclosures, the defendants may not rely on the statute of limitations defense until the plaintiff is placed on inquiry notice that the filings were fraudulent. The court said that although shareholders may be expected to exercise reasonable diligence with respect to their shares, that diligence does not require a shareholder to conduct complicated statistical analysis in order to uncover alleged malfeasance. Put succinctly, the court held that “[i]naccurate public representations as to whether directors are in compliance with shareholder-approved stock option plans constitute fraudulent concealment of wrongdoing sufficient to toll the statute of limitations.”

The tenor of the opinion suggests that if the plaintiff is successful in proving the allegations in his complaint, the court will have little difficulty finding that the defendant directors and compensation committee members breached their duty of loyalty. In that regard, the court stated the following, in a footnote concerning whether the complaint should be dismissed for failure to directly allege knowledge on behalf of the directors:

Yet, it is difficult to understand how a plaintiff can allege that directors backdated options without simultaneously alleging that such directors knew that the options were being backdated. After all, any grant of options had to have been approved by the committee, and that committee can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant. Nor is it any defense to say that directors might not have had knowledge that backdating violated their duty of loyalty. Directors of Delaware corporations should not be surprised to find that lying to shareholders is inconsistent with loyalty, which necessarily requires good faith.

In a footnote, the court alluded to another case decided the same day, suggesting that similar concerns and analysis would apply to allegations of spring-loading options. The court said, in that regard:

Although the mechanics of backdating differs from the mechanics of spring loading, each practice encompasses an element of intentional dissembling, either as to the date of the option grant, or as to the existence of potentially favorable information unavailable to the market and to all other shareholders. See In re Tyson Foods, Inc. Consol. S’holder Litig., [2007 WL 1018209,] ___ A.2d ___, (Del. Ch. 2007).

[New Heading] Fiduciary Breach: Spring-Loaded Options

The decision of the Court of Chancery of Delaware in In re Tyson Foods, Inc., 2007 WL 1018209 (Del. Ch. 2007) is lengthy and complex. It addresses not only a challenge to allegedly spring-loaded options, but also other forms of allegedly excessive or inappropriate compensation. As with Ryan, supra, the decision rules on defendants’ motion to dismiss, so certain allegations in the plaintiffs’ complaint were accepted as true. The plaintiffs made several allegations that the compensation committee, at the behest of several board members, “spring-
loaded” certain option grants. In particular, plaintiff alleged that days before Tyson would issue press releases that were very likely to drive stock prices higher, the compensation committee would award options to key employees. The court also made note of a different grant timing mechanism, with an opposite effect, “bullet dodging,” where options are granted after the release of materially damaging information. The court did not, however, suggest that the defendants had engaged in such behavior.

With respect to the spring-loading allegations, the court first addressed whether the three year statute of limitations applicable to breaches of fiduciary duty had been tolled. Because the plaintiffs alleged that the defendants knowingly spring-loaded options granted to key executives and directors while maintaining in public disclosures that those options were issued at market rates, the statute of limitations would be tolled under the “fraudulent concealment” doctrine. In addition, the statute of limitations would be tolled under the doctrine of equitable tolling because the plaintiffs were entitled to rely upon the competence and good faith of those protecting their interests, and “[i]t is difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at “market rate” and simultaneously withheld that both the fiduciary and the recipient knew at the time those options would quickly be worth much more.” The court concluded that it would be inappropriate to infer that the plaintiffs were on inquiry notice of injury simply because some relevant information was in the public domain. The court said that “reasonable diligence” does not include an obligation to “sift through a proxy statement, on the one hand, and a year’s worth of press clippings and other filings, on the other, in order to establish a pattern concealed by those whose duty it is to guard the interests of the investor.” The court noted that although the complaint contained allegations sufficient to justify tolling the statute of limitations for purposes of deciding the motion to dismiss before the court, at trial the defendants would have the opportunity to present evidence showing that the plaintiffs were, in fact, on inquiry notice. In that regard, the court suggested that the defendants might establish that financial analysts, institutional investors, or academic researchers had published research suggesting that Tyson’s directors favorably timed option grants long before the complaint was filed.

As to the substance of the spring-loading allegations, the court noted that the compensation committee, which comprised independent directors, enjoyed a presumption under Delaware law that its actions were prima facie protected by the business judgment rule. Because the plaintiffs were unsuccessful in suggesting that the compensation committee members lacked independence, the plaintiffs were required to demonstrate that the grant of options could not be within the bounds of the compensation committee’s business judgment. The court said this is a high hurdle, noting that “where a director is independent and disinterested, there could be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.” (Quoting Gagliardi v. TriFoods Int’l, Inc., 623 A.2d 1049 (Del. Ch. 1996).) The court said whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than whether a board may grant backdated options. As to the latter, the court said “[a]t their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date the grant was actually made. Allegations of spring-loading implicate a much more subtle deception.” In a footnote, the court expanded on its view that the backdating cases seem clearer in terms of their potential for involving violations of directors’ duty of loyalty, stating:
Although similar to spring-loading, the backdating of options always involved a factual misrepresentation to shareholders. Issuance of options in conjunction with such deception, and against the background of a shareholder-approved stock-incentive program, amounts to a disloyal act taken in bad faith. *See Ryan v. Gifford (sic), ___ A.2d ____, (Del. 2007) (sic).*

With respect to spring-loaded options, the court could imagine a situation in which spring-loading might not involve a violation of the duty of loyalty or bad faith. The court explained:

The touchstone of disloyalty or bad faith in a spring-loaded option remains deception, not simply the fact that they are (in every real sense) “in the money” at the time of issue. A board of directors might, in an exercise of good faith business judgment, determine that in the money options are an appropriate form of executive compensation. Recipients of options are generally unable to benefit financially from them until a vesting period has elapsed, and thus an option’s value to an executive or employee is of less immediate value than an equivalent grant of cash. A company with a volatile share price, or one that expects that its most explosive growth is behind it, might wish to issue options with an exercise price below current market value in order to encourage a manager to work hard in the future while at the same time providing compensation with a greater present market value. One can imagine circumstances in which such a decision, were it made honestly and disclosed in good faith, would be within the rational exercise of business judgment. But the facts alleged in this case are different.

In contrast, in the current case, the allegations of spring-loading were actionable because:

Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception. A director’s duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom he is a fiduciary. It is inconsistent with such a duty for a board of directors to ask for shareholder approval of an incentive stock option plan and then later to distribute shares to managers in such a way as to undermine the very objectives approved by shareholders. This remains true even if the board complies with the strict letter of a shareholder-approved plan as it relates to strike prices or issue dates. (Citation omitted.)

* * * * *

The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he knows those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.
The court said that its conclusions rest upon at least two premises, each of which should be (and, in the instant case, had been) alleged by plaintiffs to show that spring-loaded options issued by a disinterested and independent board are beyond the bounds of business judgment:

First, a plaintiff must allege that options were issued according to a shareholder-approved employee compensation plan. Second, a plaintiff must allege that the directors that approved spring-loaded (or bullet-dodging) options (a) possessed material non-public information soon to be released that would impact the company’s share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options. Such allegations would satisfy a plaintiff’s requirement to show adequately at the pleading stage that a director acted disloyally and in bad faith and is therefore unable to claim the protection of the business judgment rule. Of course, it is conceivable that a director might show that shareholders have expressly empowered the board of directors (or relevant committee) to use backdating, spring-loading, or bullet-dodging as part of employee compensation, and that such actions would not otherwise violate applicable law. But defendants make no such assertion here.

(Emphasis added.)

The Delaware Chancery Court’s decisions in Ryan and Tyson seem to telegraph the court’s sympathy for fiduciary breach claims brought in cases involving the backdating or spring-loading of options. The Tyson decision also seems to offer a preview of one type of remedy which may be available where a plaintiff is successful. In Tyson, the plaintiffs made claims for unjust enrichment against various of the individual defendants, alleging that those defendants benefited at the expense of the company through self-dealing transactions and breaches of their fiduciary duties. The court noted that by making this claim, the plaintiffs sought to seize the opportunity to assign liability to individual directors without needing to demonstrate fault with respect to those directors. The court explained that unjust enrichment is “the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.” (Citing Schock v. Nash, 732 A.2d 217 (Del. 1999).) Importantly, a defendant may be liable “even when the defendant retaining the benefit is not a wrongdoer” and “even though he may have received [it] honestly in the first instance.” (Again, citing Schock.) The court stated that the structure of the complaint suggests that if certain directors were to be found liable for breaches of fiduciary duty, the plaintiffs’ unjust enrichment claims would allow the court to force other directors to disgorge, for example, improperly spring-loaded options or profits from related-party transactions, without having to show a breach of fiduciary duty on the part of a particular director.

[New Heading] Fiduciary Breach: Disclosure Concerning Option Backdating, Corporate Merger

The Court of Chancery of Delaware considered whether directors breached their duty of disclosure relating to pending stock option backdating litigation when seeking shareholder approval for a merger of the company. Louisiana Municipal Police Employees’ Retirement
System v. Crawford, 918 A.2d 1172 (Del. Ch. 2007). The plaintiffs made allegations against the board of directors of Caremark Rx, Inc., in connection with Caremark’s merger with CVS Corporation. The lawsuit was brought by shareholders of Caremark and by Express Scripts, Inc., which had been unsuccessful in its unsolicited bid for Caremark. During the pendency of Caremark’s merger negotiations with CVS, the Department of Justice and SEC were apparently conducting an investigation into possible stock option backdating by Caremark. The merger with CVS had the effect of protecting the Caremark directors and executives from possible liability for option backdating in three ways. First, the new merged entity agreed to contractually honor any grant of options awarded by Caremark, whether or not the grants were later found to have been made in violation of the Caremark board’s fiduciary duties. Second, the combined company agreed to indemnify all past and present directors of Caremark either “to the extent such individuals are indemnified pursuant to Caremark’s certificate of incorporation and bylaws in effect as of the date of the merger agreement” or “to the fullest extent permitted by law.” Finally, the merger could eliminate the standing of derivative plaintiffs in certain ongoing backdating lawsuits.

The court found that the Caremark board did not breach its duty of disclosure to shareholders regarding the vesting of, and indemnification concerning, stock options which could be voided on the ground they were issued in violation of the stock option plan (but would nevertheless be honored under the merger agreement). The court held that shareholders received sufficient information to surmise that the alleged backdated options would be honored by the surviving corporation. That is because the proxy explained that “each Caremark option . . . will vest and become fully exercisable at the effective date of the merger.” The court found it significant that no where did the agreement exclude options granted in violation of the stock option plans. As to indemnification, the court found that the disclosures provided shareholders with sufficient notice regarding CVS’ indemnification of Caremark directors and officers for alleged backdating. In particular, the provision indicating that the directors would not only be indemnified to the extent provided under Caremark’s certificate of incorporation and bylaws, but also “to the fullest extent permitted by law” were sufficient to inform shareholders that CVS would indemnify the directors in claims regarding backdated options.

Waste/Fiduciary Breach: Approval Process – Board’s Duties of Loyalty and Care, Waste, CEO’s Duty of Loyalty

In a case applying principles established in In Re Disney Co. Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003), the Delaware Chancery Court refused to dismiss claims that a board had breached its duties of loyalty and due care in approving certain components of executive compensation. The court also refused to dismiss a claim that the CEO breached his duty of loyalty in connection with the process for setting his own compensation. The Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, 2004 WL 1949290 (Del. Ch. 2004).

The court concluded that a majority of the board members who approved the compensation arrangements at issue were disinterested and independent, but that the board might nevertheless have breached its fiduciary duties to the company. Some claims were dismissed because the company’s charter included protection offered under 8 Del. C. § 102(b)(7), which allows corporate charters to include a provision “eliminating . . . the personal liability of a
director . . . from monetary damages for breach of fiduciary duty as a director.” There are, however, four exceptions to this ability to eliminate personal liability:

[S]uch provision shall not eliminate or limit the liability of a director:

(i) For any breach of the director’s duty of loyalty to the corporation or its stockholders;

(ii) For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

(iii) . . .; or

(iv) For any transaction for which the director derived an improper personal benefit.

As a result of the inclusion in the company’s charter of a Section 102(b)(7) provision, the court dismissed claims which did not involve a breach of loyalty and did not involve a lack of good faith or involve intentional misconduct or a knowing violation of law.

The standard the court seemed to settle on in determining whether board members could have liability where a company’s charter includes a Section 102(b)(7) provision was whether the board “consciously and intentionally disregarded their responsibilities” (quoting from In re Walt Disney Co. Derivative Litigation, 825 A.2d at 289). The court noted that while there may be circumstances in which a board may defer to corporate officers’ judgments, decisions concerning those very officers’ compensation is not one of those circumstances. Instead, a board must exercise its own business judgment in approving executive compensation.

In attempting to explain what it means for a board to “consciously and intentionally disregard” its responsibilities, the court suggested that a board’s actions would not violate the standard if merely grossly negligent. The plaintiffs, an unsecured creditors committee with the now bankrupt company, adequately alleged that board members “consciously and intentionally disregarded” their responsibilities with respect to certain compensation, when the plaintiffs alleged that the board acted blindly and without any “consideration, deliberation, or advice from any expert.” The court’s decision was simply a ruling on a motion to dismiss, so the plaintiffs’ factual assertions were accepted as true.

The court also refused to dismiss a claim against the CEO based on his alleged wrongful influence on the board concerning the setting of his own compensation. The court had this to say about the standard for a CEO (or other employee with a fiduciary obligation to a company) negotiating his or her own compensation:

In general, employees negotiating employment agreements with their employers have the right to seek an agreement containing the best terms possible for themselves. However, once an employee becomes a fiduciary of an entity, he has a duty to negotiate further compensation agreements “honestly and in good faith so as not to
advantage himself at the expense of the [entity’s] shareholders.”

In re Walt Disney Co. Derivative Litigation, 825 A. 2d at 290.
This requirement does not prevent fiduciaries from negotiating their own employment agreements so long as such negotiations are “performed in an adversarial and arms-length manner.” Id.

The court found that the creditors’ committee’s allegations, if true, could indicate that the CEO had breached his duty of loyalty and improperly engaged in a self-interested transaction. In reaching this conclusion, the court relied on a list of alleged facts concerning the CEO’s claimed control over the board. In particular, the creditors’ committee asserted that the CEO set out agendas for the board and compensation committee meetings; attended those meetings; spoke with directors outside of the meetings; negotiated his compensation packages with the board and compensation committee; and spoke with the board’s compensation consultant. The court said taken individually none of these actions would be enough to show a breach of the CEO’s duty of loyalty. However, these allegations, when coupled with allegations that the CEO reviewed and revised every draft of the compensation consultant’s reports before they were submitted to the board; the CEO exerted pressure on the compensation consultant to justify the CEO’s compensation; a letter the CEO wrote to the board inaccurately stated facts as to what the compensation committee had previously approved in terms of forgiveness of loans to the CEO (much of the compensation at issue concerned loans and their forgiveness); the CEO caused the company to disburse funds to him without corporate authority; the CEO insisted on a loan program in anticipation of an outside lender eliminating the company’s use of its credit agreement to provide loans to employees; and the CEO insisted on extending a loan forgiveness program to all of his loans, notwithstanding opposition by the compensation consultant; suggest that the CEO “may have breached his fiduciary duties by engaging in a self-interested transaction.”

The court rejected the CEO’s argument that compensation committee or board approval eliminated any breach of the duty of loyalty. Instead, if the CEO in bad faith manipulated the process of the compensation committee or board approval itself, the CEO could not benefit from the decisions reached through that process.

The court rejected plaintiffs’ claim that the board and CEO had wasted corporate assets by approving the CEO’s compensation. The court noted that waste is “an extreme test, very rarely satisfied by a . . . plaintiff,” citing Steiner v. Meyerson, 1995 WL 441999, at *1 (Del. Ch. 1995). The court suggested that there will not be waste unless what a company receives in a transaction is so inadequate that the board’s process in approving the exchange will have been irrational. This very high standard was not met.

Waste/Fiduciary Breach

The Court of Chancery of Delaware rejected a motion by Oracle Corporation’s Special Litigation Committee (“SLC”) to terminate a shareholder derivative action alleging that the company’s CEO, CFO, and two directors breached their duties of loyalty by misappropriating inside information and using it as the basis for trading decisions made for their own behalf. In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003). The court rejected the SLC’s
motion because it concluded there was reasonable doubt that the SLC’s members were independent.

To prevail on its motion to terminate the derivative action, the SLC was required to show that its members (1) were independent, (2) acted in good faith, and (3) had reasonable bases for their recommendations that the corporation not prosecute the shareholder claims.

The two members of the SLC were directors added to the company’s board only after the alleged insider trading occurred. Both were professors at Stanford University. This was a critical fact because the SLC members were, in part, being asked to investigate fellow Oracle directors who had important ties to Stanford as well. In particular, among the directors accused by the plaintiffs of insider trading were: (1) another Stanford professor, who in fact taught one of the SLC members when the SLC member was a Ph.D. candidate, and who served as a senior fellow and a steering committee member alongside that SLC member at the Stanford Institute for Economic Policy Research, or “SIEPR”; (2) a Stanford alumnus who had directed millions of dollars in contributions to Stanford during recent years, served as chair of SIEPR’s advisory board, had a conference center named for him at SIEPR’s facility, and had contributed nearly $600,000 to SIEPR and the Stanford Law School (both of which were parts of Stanford with which one of the SLC members is was closely affiliated); and (3) Oracle’s CEO, who had made millions of dollars in donations to Stanford through a personal foundation and large donations indirectly through Oracle, and who was considering making donations of his $100 million house and $170 million for a scholarship program at around the same time period as the SLC members were added to the Oracle board. After digesting these facts, the court said:

It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring SLC members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry of the SLC is too substantial for this court to ignore.

824 A.2d at 921.


The Delaware Chancery Court refused to dismiss a shareholder’s action alleging that a company’s board of directors breached its fiduciary duty when it adopted an employee incentive plan that increased the number of company shares by 46 percent, and then immediately took action to grant those shares to three executives. Sample v. Morgan, 40 EBC 2389 (Del. Ch. 2007). The board had sought, and received, approval from its stockholders for a Certificate of Amendment (the “Charter Amendment”) and a Management Stock Incentive Plan (the “Incentive Plan”) that reduced the par value of the company stock from a dollar per share to a tenth of a cent each, and authorized the issuance of up to 200,000 shares for the purpose of “attracting and retaining” key employees. The 200,000 shares represented a 46 percent increase in the number of shares issued and outstanding. Once issued, the 200,000 shares accounted for
nearly a third (31.7 percent) of the company’s voting power. The stockholders were told that the decision as to which employees would receive the shares and under what terms and conditions would be made by a committee of non-employee directors.

The stockholders approved both the Charter Amendment and the Incentive Plan, by a modest majority. The same day as the stockholder vote, the board formed a compensation committee to consider how to implement the Incentive Plan. At its very first meeting, which lasted only 25 minutes, the two member committee considered a proposal by the company’s outside counsel to grant all 200,000 shares to just three employees of the company – the CEO, the CFO, and the Vice President of Manufacturing. All were directors of the company and they collectively comprised a majority of the company’s five member board. Within 10 days, the board approved a version of that proposal at a 20 minute meeting. Although the Committee adopted a vesting schedule for the grants that extended for as much as 14 years and required the recipients to remain with the company, all 200,000 shares could be voted by the recipients immediately and the recipients were to receive dividends immediately. The recipients were required to pay only a tenth of a penny per share. Soon thereafter, the Compensation Committee decided to cause the company to borrow $700,000 to cover the taxes owed by the recipients on the shares they received. For the year in which the arrangement was approved, the company’s net sales were less than $10 million and it lost over $1.7 million before taxes. In determining the recipients’ tax liability, the Compensation Committee estimated the value of the shares granted to be $5.60 apiece.

It appeared that the purpose of the actions the shareholders had approved had, in fact, been to provide the three individuals with “an incentive to grow the company and increase shareholder value” and to protect against a third party gaining significant voting control over the company. Contemporaneous with the approval of the Incentive Plan, and not disclosed to stockholders, the company had entered into a contract with a buyer of the company’s largest existing block of shares in which the company agreed that for five years it would not issue any shares in excess of the 200,000 that were to be issued if the Charter Amendment and Incentive Plan were approved. The stockholders were not told that, as a result, they were authorizing the issuance to management of the only equity the company could issue for five years.

The court refused to dismiss the claim by shareholders that the grant of the 200,000 shares was a wasteful entrenchment scheme designed to ensure that the recipients would retain control of the company. The complaint alleged that the stockholders’ approval of the Charter Amendment and Incentive Plan were procured through materially misleading disclosures, because the directors failed to disclose that the Charter Amendment and Incentive Plan had resulted from planning between the company’s outside counsel and the company’s CEO to allow the recipients to own “a significant equity stake” in the company “as incentive for them to grow the company and increase stockholder value, as well as to provide them with protection against a third party . . . gaining significant voting control over the company.” While the court noted that the test for waste is stringent, it would be “error to determine” that the board could not, as a matter of law, commit waste by causing the company to go into debt to give a tax-free grant of nearly one third of the company’s voting power and dividend stream to existing managers with entrenchment motives and who comprise the majority of the board in exchange for a tenth of a penny per share. The court alternately seemed to characterize the complaints as involving allegations for fiduciary duties and waste.
Reversing much of a stunning trial court decision against the former CEO of the New York Stock Exchange, a New York State appeals court substantially restricted the New York Attorney General’s grounds for seeking recovery of compensation paid to the CEO. People v. Grasso, 2007 WL 1322360 (N.Y.A.D. 2007). The appellate court concluded that the Attorney General could not bring certain causes of action against directors or officers of the NYSE for violations of New York’s not-for-profit-corporation law (“N-PCL”) since the statute itself provides no support for the Attorney General’s standing to bring such claims, and since the express statutory authority of the Attorney General to bring suit for certain violations of the N-PCL requires that the director or officer be at fault in some fashion (for example by having knowledge of the unlawfulness of the complaint or act or having failed to have acted in good faith), yet the alleged violations of the N-PCL would not necessarily involve fault of the same character. The court held that the Attorney General could bring an action alleging that the payment of unreasonable compensation and benefits to the CEO was an unlawful conveyance of the not-for-profit’s assets, if he could establish that the CEO knew of the unlawfulness of the conveyance. Finally, the court concluded that the Attorney General could bring an action against the CEO for breach of fiduciary duty for influencing and accepting excessive compensation, if the CEO failed to act in good faith in executing his duties to the corporation as an officer or director.

Shareholder Derivative Action: Corporation’s Lack of Independence Concerning Whether to Prosecute Lawsuit

A federal district court refused to dismiss a shareholder derivative action involving allegations that long-term incentive plan benefits should not have been triggered by shareholder approval of a merger, where the merger was not ultimately consummated. Klein v. FPL Group, Inc., 2004 WL 302292 (S.D. Fla. 2004). The court found that the board of directors and a committee appointed by it to act independently under Florida corporate law in deciding whether to terminate the derivative action were not, in fact, independent and therefore could not terminate the lawsuit. The court found a lack of independence because the board and committee members were among those who had approved the transactions at issue and were defendants in the lawsuit. In particular, the CEO, who had a significant financial interest at risk, was personally instrumental in selecting members of the committee formed to determine whether to prosecute the class action; legal counsel chosen for the committee had been involved in developing the change in control language at issue, and had been recommended by a defendant who was a former member of the law firm and had received over $6 million in change in control payments; and the company’s management issued public statements opining on the legality of the issues in question prior to the board taking final action on the committee’s report.

Collateral Estoppel

Two former executives’ claims for incentive compensation were barred by collateral estoppel where the executives had previously unsuccessfully prosecuted a class action for monies under a separate, though very similar, incentive compensation plan. Chairnoff v. National Westminster Bank, N.A., 309 F.Supp.2d 581 (S.D. N.Y. 2004). The earlier class action had involved a stock appreciation rights plan, while the later lawsuit involved a restricted phantom
stock unit plan. The primary difference among the plans was that the phantom stock unit plan compensated participants based on the fair market value of the company, not merely the increase in that fair market value. The lawsuits concerned an adjustment made in the number of phantom shares by reason of capital payments made to the employer from its parent company.

[New Heading] **Standard of Review**

The First Circuit refused to apply an arbitrary and capricious standard in reviewing a stock option plan committee’s denial of benefits where the option agreement at issue failed to give the committee discretionary authority to interpret the plan’s provisions, even though the plan document under which the grant was made did grant that authority. *Kerkhof v. MCI Worldcom, Inc.*, 282 F.3d 44, 27 EBC 2806 (1st Cir. 2002), on remand, 204 F.Supp.2d 74, 28 EBC 2599 (D. Me. 2002). The employer’s argument for applying an arbitrary and capricious standard was made under state law, since the plan was not subject to ERISA.

[New Heading] **Employer’s Unclean Hands**

A federal district court prevented an employer from exercising its contractual right to buy back stock from a former employee where the employer delayed for two years responding to the former employee’s request for more information about the employer’s buy back rights. The stock had been purchased through the exercise of options. The former employee requested more information about the employer’s buy back rights in response to a letter from the employer indicating that it was exercising those rights. The court concluded that, due to the employer’s delay in responding to the employee’s questions, the employer did not have clean hands and could not avail itself of the equitable remedies of restitution or specific performance. *Medtronic, Inc. v. Wohlfeld*, 2002 WL 523873 (D. Minn. 2002).

[New Heading] **Arbitration**

A federal district court concluded that an employer must arbitrate whether an amendment to an employment agreement was invalid, where the employment agreement being modified required the arbitration of all disputes relating to, or arising under, the agreement. The employer argued the amendment was invalid because (a) there was no consideration given by the employee for the amendment, and (b) the employee breached his fiduciary duty to the corporation and shareholders by negotiating with the CEO for an “obscene” level of compensation for himself as senior vice president of human resources. The employee argued for arbitration, presumably in part, because the sole function of the arbitrator under the agreement was to enforce the agreement pursuant to its terms, with no power to vary the terms of the agreement. *Raytheon Co. v. Donovan*, 208 F.Supp.2d 99, 29 EBC 1085 (D. Mass. 2002).

[New Heading] **Attorneys’ Fees**

A federal district court granted an employer attorneys’ fees where a former employee’s claim for benefits was not substantially justified. The employee had made no effort to exhaust remedies, had used discovery to engage in a “fishing expedition,” and the employee’s actions were taken in bad faith for the sole purpose of harassing the employer, which had refused to accede to the employee’s severance demands. *Stark v. PPM America, Inc.*, 29 EBC 2919, 2003.

An executive was not entitled to attorneys’ fees under the provisions of his employment agreement where the claims he brought (unsuccessfully) strayed “far field” from the provisions, rights, or benefits set forth in his employment agreement. Kleinberg v. Radian Group, Inc., 2003 WL 22723014 (S.D. N.Y. 2003), adopting magistrate report and recommendation, 31 EBC 2814, 2003 WL 22420501 (S.D. N.Y. 2003).

An employer was not required to pay attorneys’ fees to a former CEO under the terms of the executive’s employment agreement where the executive’s claims were meritless. Kaul v. Hanover Direct, Inc., 296 F.Supp.2d 506, 32 EBC 1222 (S.D. N.Y. 2004), aff’d, 148 Fed. Appx. 7 (2d Cir. 2005) (unpublished). This was because the agreement required only the payment of “reasonable” legal fees, and fees incurred in pursuit of meritless claims were considered not to be reasonable.

[New Heading] Prejudgment Interest

A federal district court concluded that a former employee was entitled to prejudgment interest on the liquidated value of vested options where the employer delayed payment under its option program because the former employee refused to release the claims at issue in the litigation. Edwards v. Schrader-Bridgeport Int’l, Inc., 205 F.Supp.2d 3, 28 EBC 1946 (N.D. N.Y. 2002). The court also determined that where an option agreement was ambiguous, interpretation of the agreement was an appropriate issue for determination by a jury.

[New Heading] Delegation of Claim Decision

The Tenth Circuit, in considering an employee’s claim for accelerated vesting of stock options, concluded that the employer’s compensation committee, which under the plan terms had “plenary authority” to make “final and binding” decisions concerning plan interpretation, had improperly allowed a vice president of human resource to decide the employee’s claim for accelerated vesting. Mauldin v. WorldCom, Inc., 263 F.3d 1205, 26 EBC 2378 (10th Cir. 2001). The court found no evidence that the committee had properly delegated to the vice president authority to determine claims, nor had it properly ratified the vice president’s denial of the employee’s claim. Although the committee had “ratified and approved the prior appointment of, and delegation of the committee’s authority to,” the vice president, the court required more for a proper delegation or ratification. In part, the committee’s action failed as a proper delegation because it occurred after the claim denial. The committee’s purported ratification was ineffective because the court concluded that to properly ratify an agent’s stock option vesting decisions, the committee would need to be at least minimally aware of the material facts, such as the vesting decisions made by the agent and the agent’s basis for making them. The minutes of the committee’s meeting at which it ratified the vice president’s conduct did not indicate that the committee was even aware of the particular claim at issue, much less knew any of the facts underlying the claim.
Importantly, the court acknowledged that the committee may impliedly delegate its authority. The employer had not, however, argued that the committee had done so. The court, in discussing the possibility of implied delegation, stated as follows:

[The employer] has also failed to establish an implied delegation of authority to [the vice president]. This would not be a difficult argument to make, for common sense dictates that:

With a Fortune 500 Company . . . it is necessary that many different and varying functions and duties be delegated to officers and employees of the corporation in order that the operation of the corporation may be conducted in a continuous, systematic and profitable manner. This often involves giving wide latitude and discretion to corporate personnel. To require that a company . . . draft a corporation resolution authorizing its personnel to make everyday decisions regarding the conduct of the corporation’s affairs would be to place unduly burdensome restrictions on a large corporation . . .

*Karam v. Travelers Ins. Co.*, 813 F.2d 751, 753 (5th Cir. 1987) (quoting opinion below). However, [the employer] does not argue in its brief that the Committee had impliedly delegated authority to [the vice president], although such an argument, coupled with a more complete record in support, might have been persuasive. Thus, [the employer] has waived this argument, *Gaines-Tabb v. ICI Explosives, USA, Inc.*, 160 F.3d 613, 624 (10th Cir. 1998), and has failed to show that [the employer’s] Compensation Committee adequately delegated authority to [the vice president] to decide [the former employee’s] request.

[New Heading] *Declaratory Action: Jurisdiction*

A court had no jurisdiction to render a declaratory judgment that a company that had spun-off plaintiffs’ former employer was secondarily liable to pay nonqualified benefits (should the spun-off company fail to pay those amounts). *Bolton v. Actuant Corporation*, 2004 WL 1136551, 32 EBC 3032 (C.D. Cal. 2004). The court concluded that there was no case of actual controversy under the Declaratory Judgment Act; instead, the action concerned a defense that the company might raise if later sued.

[New Heading] *Statute of Limitations: Fraud or Concealment Exception, ERISA Fiduciary Claim*

In *Evanson v. Price*, 2006 WL 2829789, 39 EBC 2947 (E.D. Cal. 2006), individuals who served as ESOP trustees and members of the ESOP’s administrative committee allegedly breached their fiduciary duties under ERISA by concealing a Watson Wyatt report concluding that compensation proposed for them would place their compensation far above market levels.
The plaintiffs’ fiduciary claims survived the defendants’ 12(b)(6) motion, in which the defendants argued that the plaintiffs’ claims were barred by the statute of limitations. The statute of limitations did not bar the claims because, taking the plaintiffs’ allegations as true, the fraud or concealment exception to the running of ERISA’s statute of limitations for fiduciary breach applied.

[New Heading] Complete Preemption: Top-Hat Plan

A federal district court held that a claim for benefits under a top-hat plan was completely preempted. *Hutchison v. Crane Plastics Manufacturing Ltd.*, 2006 WL 3346117, 39 EBC 1282 (S.D. Ohio 2006). The court first determined that the top-hat plan was not an “excess” plan under ERISA § 3(36) exempt from the application of ERISA. The plan permitted voluntary deferrals, with some employer match. It did not, however, make mention of Tax Code Section 415. Because the top-hat plan was not an excess plan, it was subject to ERISA. The plaintiff’s claims for benefits, which were framed on state law theories, were therefore completely preempted so that removal to federal court was appropriate.


A former executive’s state law quantum meruit claim, alleging that her former employer was unjustly enriched by failing to pay severance benefits, was completely preempted. *Curcio v. Hartford Financial Services Group*, 469 F.Supp.2d 239, 40 EBC 2025 (D. Conn. 2007). As a result, the executive’s claim was removable to federal court. The court held that the claim was completely preempted under the Supreme Court’s guidance in *Aetna Health Inc. v. Davila*, 542 US 200, 32 EBC 2569 (2004), because the executive could have brought her claim as an ERISA Section 502(a)(1)(B) for benefits, and because the employer’s alleged liability was derived from or dependent on the existence of the administration of an ERISA-regulated severance plan so that there was no legal duty independent of ERISA implicated by the employer’s actions.

[New Heading] Federal Diversity Jurisdiction: Stock Options, Amount in Controversy

In a surprising conclusion, a federal district court held that for federal diversity jurisdiction purposes, the amount in controversy in a matter involving an alleged failure of an employer to allow an employee to exercise stock options was determined by looking at the exercise price under the option, not the spread. *Preece v. Physicians Surgical Care, Inc.*, 2006 WL 1470268, 38 EBC 1402 (S.D. Tex. 2006). The opinion includes some language suggesting that the parties may not have adequately informed the court as to how stock option programs operate.


A federal district court held that the fiduciary exception to the attorney-client privilege does not apply to a claim for benefits under a top-hat plan. *Marsh v. Marsh Supermarkets, Inc.*, 2007 WL 1021410 (S.D. Ind. 2007). The fiduciary exception does not apply to overcome the attorney-client privilege because ERISA’s fiduciary duty rules do not apply to top-hat plans.
A federal district court refused to permit discovery relating to a top-hat plan that was not the subject of the litigation. Roberts v. Fearless Farris Service Stations, Inc., 2007 WL 625423 (D. Idaho 2007). The plaintiff had sought discovery relating to the plan in an attempt to establish that the top-hat notice to be filed with the Department of Labor for that plan indicated that a separate plan, that was the subject of the litigation, was also a top-hat plan. In refusing the discovery request, the court held that documents pertaining to another top-hat plan had no relevance in determining whether the plan at issue was a top-hat arrangement. In particular, even if a filing were made for the other plan, whether it also listed the plan at issue as a top-hat arrangement would not be determinative as to whether that arrangement was, in fact, a top-hat plan.

Mergers and Acquisitions

Change in Control

A federal district court concluded that there was no acceleration of the vesting of options or restricted shares under a change in control provision of an incentive plan where a merger was approved by the employer’s shareholders, but the merger did not in fact take place (European Union regulators blocked the transaction). Bohan v. Honeywell Int’l, Inc., 30 EBC 1268, 2002 WL 31767786 (D. Minn. 2002), aff’d. 366 F.3d 606, 32 EBC 2223 (8th Cir. 2004). The court read the plan’s change in control provision as requiring not only approval by the employer’s shareholders, but also that the merger actually occur.

In an unpublished decision, a state appeals court considered when a change in control was considered to occur. This was important because the plaintiff was employed on the date a merger agreement was signed by the employer’s board of directors, but not on the later date when the company’s shareholders approved the transaction. The employee’s unvested restricted stock and stock options were to be cancelled on termination of employment, absent a change in control preceding that date. The court concluded that, for purposes of the restricted stock and stock option program at issue, a change in control occurred when the employer’s shareholders approved the transaction, not on the earlier date when the merger agreement was signed by the company’s board of directors. Pasquel v. Airtouch Communications, Inc., 2002 WL 31813099 (Cal. App. 4 Dist. 2002) (unpublished).

In another unpublished decision, a state appellate court held that a former executive’s promissory estoppel claim was preempted by ERISA where the executive complained that he quit his job, and thereby lost out on benefits under a change in control severance program, as a result of the company’s CEO falsely representing that the company would not be sold. Cornelison v. Pioneer Hi-Bred International, Inc., 674 N.W.2d 684, 32 EBC 1390 (Iowa App. 2003).
Nonqualified Benefit Ambiguities

[New Heading] Letter Agreement: Sufficiently Definite

A state appeals court held that a letter agreement tersely providing for a grant of phantom stock units was sufficiently definite, and met the other requirements necessary for a valid contract (including mutual assent), to be enforceable. The letter provided, in relevant part:

A phantom unit plan will be adopted by the Board of Managers in which you will be granted 4,000 phantom units with an initial value of $40.00 per unit.

The court rejected the employer’s argument that upon the employer’s termination of the executive no amount was payable with respect to the phantom units because they had neither vested nor increased in value. The court rejected, under the language of the letter agreement, the argument that a vesting schedule should apply even though the employer’s previous phantom unit plan had included a three year vesting requirement, and rejected the notion that only amounts reflecting increases in the value of the phantom units were payable. Instead, the full value of the units were to be paid. Hopmayer v. Aladdin Industries, LLC, 2004 WL 1283984 (Tenn. Ct. App. 2004).

[New Heading] Unilateral Contracts/Consideration

A federal trial court concluded that an exchange of e-mails with an employee concerning stock options and restricted equity units could create a unilateral contract which would bind the employer. Levy v. Lucent Technologies, Inc., 2003 WL 118500, 30 EBC 1497 (S.D. N.Y. 2003). At issue was whether the employer was bound, through an e-mail exchange, to vest certain stock options following a merger, where an at-will employee had agreed to remain at the company following the merger. The court concluded that if the terms of the exchanged e-mails were to bind the employer, it would be by reason of a unilateral contract. A bilateral contract could not have been created by the e-mails because the at-will employee’s promise to remain at the company would not constitute adequate consideration. The court concluded that if one of the e-mails constituted an offer that was intended to induce the employee to stay, and if the employer benefited from the employee remaining with the company, the offer could be enforced as a unilateral contract.


A federal trial court concluded that an oral contract for the transfer of stock as compensation was unenforceable under Maine’s statute of frauds. The agreement violated the statute of frauds because the parties understood that the transfer of stock would likely not occur within one year. Ingram v. Rencor Controls, Inc., 256 F.Supp.2d 12, 30 EBC 2570 (D. Me. 2003). The court applied Maine law because the majority of services to be provided by the employee were to be rendered in Maine. The court also held that the employee could not recover on an unjust enrichment theory because the compensation sought was part of a broader contractual employment arrangement.
A federal district court concluded that it must disregard the terms of correspondence which accompanied plan materials for a phantom equity program, as well as any prior oral representations, concerning the value of phantom equity units. The court reached this conclusion because the plaintiffs’ employment contracts and the terms of the plan itself addressed the value of the units. *Bandy v. LG Industries, Inc., Equivalent Ownership Plan*, 2003 WL 21499017, 30 EBC 2540 (E.D. Pa. 2003), *subsequent determination*, 2003 WL 22100876 (E.D. Pa. 2003) (attorneys’ fee issue).

The plaintiffs’ employment contracts had provided that a portion of the plaintiffs’ compensation would be paid as a percentage of the company’s total value. One of the plaintiffs was, for example, granted a 2% ownership interest. The plaintiffs were to be fully vested in these interests after five years of employment. The actual mechanism for paying employees for their ownership interests at the time of vesting was set forth in a formal “Equivalent Ownership Plan.” The plan, in fact, provided participants with “units,” rather than percentage interests. Correspondence accompanying the plan materials said that each unit would have a fixed value at the time of vesting equal to $37,000. The plan document, however, said this was the *initial* value of the units on the effective date of the plan, but that the current value of those units would depend on the actual book value of the company at the time of vesting. When the plaintiffs vested, the value of their units was roughly $11,000. Plaintiffs argued they were entitled to the $37,000 per unit amount indicated in the correspondence accompanying the plan materials, and made arguments based on alleged prior oral representations.

The court refused to consider the terms of the correspondence or any oral representations because the plaintiffs’ employment contracts granted a specific percentage of the company, with no mention of a minimum payout, and because the terms of the plan document did not support any guarantee as to the value of the ownership units.

A state appeals court concluded there was no common law forfeiture of benefits under a top hat arrangement by reason of an employee’s fraud or a breach of fiduciary duty owed to the employer, where the benefits at issue accrued prior to the employee’s wrongdoing. The court reached this conclusion because the top hat agreement did not include a forfeiture provision that would apply to the type of misconduct at issue. *Thornton Oil Corp. v. Perconti*, 2003 WL 1340715, 29 EBC 2894 (Ky. App. 2003) (unpublished).

The Third Circuit cited, and effectively followed, the decision in *Aramony v. United Way Placement Benefit Plan*, 191 F.3d 140, 23 EBC 1865 (2d Cir. 1999), *on remand*, 86 F.Supp.2d 199, 23 EBC 2639 (S.D. N.Y. 2000), *vacated*, 254 F.3d 403, 26 EBC 1647 (2d Cir. 2001), in refusing to imply a forfeiture provision in an employment contract. *Fields v. Thompson Printing Co., Inc.*, 363 F.3d 259, 32 EBC 1673 (3d Cir. 2004). The plaintiff, who was president of the company, was terminated by the CEO when three female employees alleged that the president had sexually harassed them by creating a hostile work environment. The court noted that the president’s employment agreement provided that if the president were terminated by the company (involuntarily), all of the president’s benefits under the agreement would continue.
The court said the contract did not differentiate between termination with or without cause, and as a consequence, the former president was entitled to continued compensation and benefits under the agreement (presumably, for the balance of the 10-year term of that agreement, followed by nonqualified deferred compensation retirement benefits, continued medical benefits at no cost, and the use of two cars). The court refused to look beyond the plain language of the contract to find either that it would violate public policy to enforce the agreement given the alleged acts of sexual harassment, or that the alleged acts breached the president’s obligation under the agreement, thereby terminating the company’s obligation to continue to pay him.

In a straightforward decision, the Sixth Circuit concluded that a supervisor discharged for criminal activity (participating in a kickback scheme that involved the supervisor’s receipt of illegal bribes from third party vendors) was not entitled to benefits under the company’s nonqualified plan. The plan provided that no benefits would be payable in the event of a discharge for cause. McGrew v. General Motors Corp., 159 Fed. Appx. 616, 35 EBC 2479 (6th Cir. 2005) (unpublished).

A credit union acted properly in denying benefits to its president and CEO under a nonqualified deferred compensation agreement, where the CEO approved loans to an individual in violation of policies, bylaws, and regulations governing the credit union. Picard v. Best Source Credit Union, 2005 WL 2665639, 35 EBC 2244 (E.D. Mich. 2005). The court upheld the employer’s determination, as plan administrator, that the CEO’s actions constituted “acts of willful malfeasance or gross negligence in a matter of material importance to the Employer.” This determination resulted in the CEO’s forfeiture of his nonqualified deferred compensation.

[New Heading] Forfeiture for Voluntary Termination

The Third Circuit, in an unpublished decision, enforced a New York choice of law provision in a deferred compensation arrangement. Schunkewitz v. Prudential Securities Inc., 99 Fed. Appx. 353, 2004 WL 896660, 33 EBC 1461 (3d Cir. 2004) (unpublished). Under that arrangement, deferrals were forfeited if an employee were terminated for cause or voluntarily left the company before the end of a three year period. Applying New York law, the court upheld the forfeiture provision, noting that such a provision will be enforced so long as it is not triggered by an employee’s termination without cause. Citing the New York Court of Appeals decision in Marsh v. Prudential Securities Inc., 1 N.Y.3d 146, 770 N.Y.S.2d 271, 802 N.E.2d 610, 32 EBC 1401 (N.Y. 2003), the court also held that the forfeiture provision did not violate New York’s statutory wage law requiring payment of all earned income. The relevant provision, Section 193 of the New York labor law, specifically authorizes certain deductions from employees’ wages that “are expressly authorized in writing by the employee and are for the benefit of the employee.”

[New Heading] Forfeiture for Competition

The Seventh Circuit upheld a noncompetition provision in a stock option arrangement in Tatom v. Ameritech Corp., 305 F.3d 737, 28 EBC 2860 (7th Cir. 2002). The court concluded that a provision in the stock option agreement providing for the forfeiture of options upon the former employee working for a competitor was not an unreasonable anti-competitive provision. In dicta, the court indicated that even if the provision were unreasonable, it might nevertheless be
enforceable because it would not prevent the employee from working for a competitor, but would instead simply cause the employee to forfeit benefits.

A federal district court held that a bank was justified in ceasing to make retirement payments to a former member of its board of directors by reason of the director’s violation of a noncompete. *Hearns v. Interstate Bank*, 2006 WL 862893, 38 EBC 1956 (N.D. Ill. 2006). The former director was prohibited from competing while in the bank’s “active employ.” The court held that the director was in the active employ of the bank for purposes of this prohibition whether or not he was a common law employee, because the agreement to serve as director referred to the individual as “Employee” and referred to his activities as a director as “employment.” The court so held even though, seemingly inconsistent with this, the bank began making annual retirement payments when the director reached age 65, even though payment under the arrangement was not to be made until the later of a 65 or “retirement.” The court concluded that in helping form another bank, the director engaged in prohibited competition. As a result, the bank was justified in ceasing to make retirement payments since the defendant breached the terms of his “employment” contract. The court allowed the bank to cease making those payments even though the provisions of the employee agreement quoted in the decision did not seem to address what would happen in the event the director were to compete.

[New Heading] *Releases*

A federal district court held that requiring employees to sign a release to receive any payment under a phantom equity plan violated the Pennsylvania Wage Payment and Collection Law. *Bandy v. LG Industries, Equivalent Ownership Plan*, 2003 WL 21499017, 30 EBC 2540 (E.D. Pa. 2003). The court concluded that the Pennsylvania statute does not permit an employer to demand a release from employees as a condition of their being paid the undisputed portion of their compensation. Compensation, for this purpose, would include payments under the company’s phantom equity plan. Under the Pennsylvania law, the plaintiffs were entitled not only to the compensation due them, but also liquidated damages equal to 25 percent of the undisputed amounts owed them plus attorneys’ fees.

[New Heading] *Business Travel Accident Insurance: Death While Traveling Home*

Although the case did not involve a high-level executive, the Second Circuit made an interesting ruling concerning a business travel accident insurance policy which could have implications for executives in *Lifson v. INA Life Insurance Co. of New York*, 333 F.3d 349, 30 EBC 2148 (2nd Cir. 2003). The case involved a claim for death benefits under a group business travel insurance policy. A software engineer had left her office one late afternoon, probably headed for a daycare facility to pick up her daughter, and then home. As the employee crossed the street on the way to a nearby parking garage, she was struck by a car and died the following day. The employee’s surviving spouse argued that benefits were payable under the company’s travel accident insurance policy.

One requirement for coverage under the policy was that death be caused by an accident occurring while a covered employee was traveling on business, and in the course of the employee’s business. A magistrate judge concluded that the employee’s journey was not a business trip, and the district court consequently granted summary judgment in favor of the
insurer. The Second Circuit, however, reversed the grant of summary judgment, concluding that a fact finder could conclude that the employee was “on business . . . and in the course of . . . business.” Of interest to executives, the court based its conclusion on the likelihood that the employee would be performing work responsibilities while at home (once she arrived at her home). In the case at hand, the employer maintained an “on-call” system for its computer technical support staff, which required that staff members respond to pages for assistance. The employee was on call at the time of her death and, for reasons detailed in the opinion, the court concluded there was a likelihood the employee would in fact be required to respond to a call that evening.

In examining New York caselaw, the court reached a conclusion which might allow one to argue that an executive killed on his or her way home could be considered to have been traveling on business for purposes of travel accident insurance. In particular, the court concluded that under New York law:

An employee who can show either that they (sic) were to carry out “a specific work assignment for the employer’s benefit at the end of the particular homeward trip,” or that they (sic) engage in “so regular a pattern of work at home that the home achieves the status of a place of employment,” is within “the course of . . . employment” under New York’s worker’s compensation statute, even if injured while driving home.

333 F.3d at 354, citing Fine v. S.M.C. Microsystems Corp., 553 N.E.2d 1337, 1338-39 (1990). The court found this reference to New York worker’s compensation law to constitute substantial support for the argument that the software engineer was traveling on business and in the course of business when headed to her home. Notably, the court in its summary judgment ruling was not required to examine whether other exclusions in the travel policy precluded the payment of benefits, such as an exclusion for “commuting between the covered person’s home and place of work” and a requirement that “trips” be authorized by the employer.

[New Heading] Compensation Definition: Counting Stock Option Gains

The Fourth Circuit considered a top hat plan administrative committee’s determination that large, taxable stock option gains should not to be counted as “earnings” for purposes of calculating benefits under the plan in Scipio v. United National Bankshares, Inc., 119 Fed. Appx. 431, 2004 WL 2980756, 34 EBC 1138 (4th Cir. 2004) (unpublished). The earnings to be included under the plan were “the total earnings received from the [company] during a calendar year,” excluding specific bonuses not relevant to the court’s decision. The court found the quoted language to be ambiguous. It then reviewed the board’s decision as plan administrator under an “abuse of discretion” standard, but accorded the board less deference than if the board had no conflict of interest. (The conflict resulted from the company’s financial interest in limiting benefits under an unfunded plan.)

The factors important to the court in determining whether the board abused its discretion in determining that stock option compensation should not be counted as earnings were (a) whether the board considered adequate materials in making its decision, (b) whether it engaged
in a reasoned and principled decision-making process, and (c) whether its ultimate decision was consistent with the plan provisions and the board’s earlier interpretations of the plan.

The court found that the board took pains to gather and consider information and material from a number of sources. Notably, the board hired a national employee benefits consulting firm to make the benefit calculation and obtained an opinion from a prominent law firm on the proper interpretation of the plan’s language. The court also noted approvingly that the board contacted the former CEO and chairman of the board of directors involved at the time the plan was drafted, as well as other employees, to gain an understanding of the intent behind the plan’s provisions. Those parties apparently advised that the plan was not intended to include as earnings gains realized from the exercise of stock options. The board was consistently advised that the intent of the plan was instead to provide retirement benefits for the key executives at roughly 70 percent of their typical annual salary. The court also noted that retirement benefits for other similarly situated executives had been computed without including their stock option gains. Finally, the court found support for the board’s interpretation in the Tax Code Section 415 rules applicable to qualified retirement plans (although this reader would not have found that argument persuasive). The court, in conclusion, found that the board’s determination that earnings for nonqualified plan purposes should exclude stock option gains was “the product of a reasoned and principled decisionmaking process based upon adequate materials and inquiry, and that the decision was consistent with the purposes and goals of the Plan, the Plan provisions, and its earlier interpretations of the Plan.”

The Fourth Circuit again upheld an administrative committee’s determination that taxable stock option gains should be excluded in determining compensation for purposes of calculating benefits under a nonqualified deferred compensation program in Adams v. Louisiana-Pacific Corp., 177 Fed. Appx. 335, 37 EBC 2107 (4th Cir. 2006) (unpublished). The court examined the administrative committee’s determination under a modified abuse of discretion standard, with the amount of the court’s deference reduced to the extent necessary to counteract any undue influence resulting from the committee’s conflict of interest arising from the employer’s need to pay any benefits due from general corporate assets. The court upheld the committee’s conclusion that stock options were “fringe benefits,” so that income from the exercise of options was not counted in determining compensation under the defined benefit nonqualified plan. The court noted that in deciding whether an administrator has abused its discretion, it considers several factors, including, but not limited to: (1) the language of the plan; (2) the sufficiency of the materials considered in making the decision and the extent to which they support it; (3) whether the administrator’s determination was consistent with previous interpretations of the plan; and (4) whether the decisionmaking process was reasoned and principled.

The court found the term “fringe benefits” to be susceptible of more than one meaning, and concluded that the committee properly consulted an advisor who determined that the prior inclusion of option compensation in the calculation of other participants’ benefits was not a result of any interpretation by the committee, but was instead due to the employer’s payroll department having included option income as compensation in reporting data used by the actuary to calculate benefits. The committee also reviewed various Treasury regulations (which were not identified in the opinion) to determine whether the IRS considers stock option income to be a fringe benefit, although those regulations were inclusive. The court held that the decisionmaking process was reasonable and supported by substantial evidence, and therefore upheld the
committee’s determination to exclude stock option compensation in calculating the executive’s nonqualified benefit.

The court also upheld the committee’s decision to apply an actuarial reduction upon early retirement, even though the plan did not by its terms provide for such a reduction. That was because the court thought it reasonable to infer such a reduction since the nonqualified plan was integrated with a qualified plan that imposed such a reduction on benefits paid from the qualified plan. It is notable that the employer had earlier adopted an amendment to the nonqualified plan which clearly eliminated the early retirement reduction, but a few months later “issued a revised plan” without the amended language. It is unclear from the opinion whether the employer took formal action to repeal the prior amendment, but the court nevertheless supported the committee’s decision to apply an early retirement reduction.

For another case in which a court upheld the exclusion of nonqualified stock option compensation from the determination of compensation used to calculate defined benefit nonqualified plan payments, see *Karras v. First Colony Life Insurance Company Pension Plan*, 2006 WL 1049519, 37 EBC 2142 (W.D. Va. 2006). The court in *Karras* held that under either a modified abuse of discretion, or abuse of discretion, standard it was proper for a plan committee to exclude nonqualified stock options from the determination of compensation under both a qualified defined benefit plan and related nonqualified plan. The plans appeared to exclude from the definition of “compensation” for benefit determination purposes “other bonuses” and “similar payments.” The committee considered the stock option compensation to fall within these exclusions, indicating that the amounts were similar to a “long-term performance-type” bonus. The court seemed to find the following factors to support the committee’s decision: (1) ISOs had been excluded from compensation in the past (for, perhaps, 50 participants), (2) including stock options would increase the executive’s annual pension from $175,000 to $326,000, which was more than his highest annual compensation of $320,000 (which seemed to the court to be inconsistent with the purpose of the plans), and (3) the committee had concern that counting stock options as compensation under the qualified plan might violate the Tax Code’s nondiscrimination rules (presumably, under Section 414(s) or 401(a)(4), or both).

For a case in which an executive’s release of claims prevented the executive from arguing that stock option compensation should be included in determining benefits under a nonqualified plan, see *Linder v. BYK-Chemie USA, Inc.*, 2006 WL 648206, 38 EBC 2493 (D. Conn. 2006). The court held that a waiver of claims against the employer was also a waiver of any claim that income on the exercise of stock options was compensation under a top-hat plan. This was true even though no waiver of claims against the plan as a defendant was expressly given. The waiver given the employer protected the plan as well because top-hat plans are unfunded and, therefore, the court concluded that the employer is the real party-in-interest in a claim involving benefits under such a plan, with the plan being only a nominal defendant. As a result of the executive’s knowing and voluntary waiver releasing the employer from all claims (including claims arising under or in connection with the executive’s employment), executed at a time when the executive knew that the issue of whether compensation from the exercise of stock options was included in compensation under the top-hat plan was unresolved, the executive waived any claim that the option income was to be includable as compensation for that purpose. The court also held that the employer did not waive any claim that the executive had released his claim by failing to raise the matter during the administrative review process, where the claims review
process was never completed and therefore the executive’s claim was deemed denied. The court also concluded that ERISA’s anti-alienation provision does not prevent a waiver of benefits where there is a contested benefit claim.

[New Heading] Compensation Definition: Counting Retention Compensation

The Tenth Circuit applied an arbitrary and capricious standard in upholding a decision by a nonqualified deferred compensation plan committee that retention payments did not count as compensation under the plan’s benefit formula. Wolberg v. AT&T Broadband Pension Plan, 123 Fed. Appx. 840, 2005 WL 23683, 34 EBC 1353 (10th Cir. 2005) (unpublished). The plan expressly excluded retention payments in its definition of compensation, but the executive argued that the compensation at issue was not retention pay. The executive had been retained to facilitate a successful merger transition. His employment was a temporary assignment scheduled to last roughly a year from the date of the merger. The executive’s written employment agreement characterized a certain amount of his compensation as a “retention bonus.” The executive argued that the compensation at issue was, nevertheless, not retention pay, but instead wages which should be counted under the plan, since the amounts were payable pro rata for whatever period of time the executive was employed. In other words, the executive was to be paid a pro rata portion of the compensation in question even if he failed to stay through the end of his assignment. The court found the executive’s argument unpersuasive and upheld the committee’s decision to exclude the retention pay from the compensation used to calculate the executive’s nonqualified pension benefit.

In contrast to Wolberg, the Eighth Circuit concluded that retention bonuses must be considered as compensation in determining benefits under a top-hat plan in Craig v. The Pillsbury Non-qualified Pension Plan, 458 F.3d 748, 38 EBC 1974 (8th Cir. 2006). The court first addressed the standard of review to be used in examining decisions concerning top-hat plans. The court adopted the Third Circuit’s formulation in Goldstein v. Johnson & Johnson, 251 F.3d 433 (3d Cir. 2001). Under the Goldstein approach, since top-hat plans are not subject to ERISA’s fiduciary standards, they are treated as unilateral contracts. Applying ordinary contract principles, where the administrator is granted discretion to interpret the contract’s terms, that discretion must be exercised in good faith, and this requirement includes a duty to exercise the administrator’s discretion reasonably. In the instant case, the administrative committee failed to exercise its discretion reasonably when it excluded retention bonuses from compensation under the final average pay top-hat plan. Ironically, the committee may have had the discretion to treat the executive’s compensation after moving to a nonparticipating affiliated employer (which was when the retention bonuses were paid) as $0, which would have had the effect of excluding the retention bonuses (as well as other compensation), but the committee did not do so. It instead decided to count compensation with nonparticipating affiliates. Once it did so, it had no discretion to ignore the plain language of the plan which indicated that compensation under the arrangement included bonuses, and the court held that this would include the executive’s retention bonuses.

[New Heading] Compensation Definition: Counting Payment for Noncompete

Amounts paid to an executive upon termination of employment for an agreement not to compete were not compensation for purposes of calculating the executive’s benefits under either
qualified or nonqualified deferred compensation plans. *Karras v. First Colony Life Insurance Company Pension Plan*, 2005 WL 1712878, 35 EBC 1316 (W.D. Va. 2005). The court applied a modified abuse of discretion standard in upholding the plan committee’s denial of the executive’s claim. The committee concluded that payments for the noncompete should not be included as compensation because the plans counted compensation only for calendar years prior to the year of retirement, and the payments at issue were made in the year of retirement. In addition, under the terms of the plans, compensation did not include payments “similar” to bonus amounts, and the committee determined that the payments were similar to bonus amounts. The court seemed to agree with this determination primarily because the payments were extraordinary, rather than because of any other parallel with bonus amounts.

The court remanded to the committee the question whether compensation should include amounts realized from the exercise of stock options. (For the court’s later ruling on this issue, see the discussion above under the heading “Compensation Definition: Counting Stock Option Gains.”) The committee had not previously ruled on this claim, and the court noted the strong policy in favor of plans resolving claims internally. Finally, the court ruled that the statute of limitations for benefit claims under ERISA is five years from the date the claim is formally denied, by analogy to Virginia’s five-year statute of limitations for actions for breach of contract.

[New Heading] *Compensation Definition: Counting Severance Pay*

The Ninth Circuit concluded that severance pay did not constitute “earnings” for purposes of calculating an employee’s benefit under a nonqualified top-hat plan. *Gilliam v. Nevada Power Company*, 2007 WL 1557483 (9th Cir. 2007). The court considered a former executive’s claim that her benefit under a SERP’s final average pay formula should take into account a severance payment to her of $512,500. Taking into account this severance payment would increase the former executive’s annual benefit under the SERP from approximately $60,000 to just over $145,000. The plan calculated benefits based on “Service Earnings.” The plan included no definition of that term, but did define “Service” and “Earnings.” The term “Earnings” meant “a Participant’s total wages and salary as reported by the Company for federal income tax purposes for the calendar year.” The Ninth Circuit began by noting a split among the Circuits in terms of the proper standard of review for decisions by plan administrators of top-hat plans, but did not decide whether the *Firestone* standard of review framework applies to top-hat plans because it would reach the same conclusion under either standard of review.

The court focused on the definition of the phrase “wages and salary.” Although the plan’s definition of “earnings” made reference to amounts reported by the Company for federal income tax purposes, the court did not find it necessary to consider what the term “wages and salary” might mean under the Tax Code. That was because the plan did not define earnings in reference to wages and salary within the meaning of the Tax Code, but instead as reported by the Company for federal income tax purposes. The court looked to *Black’s Law Dictionary* for definitions of the terms “wage” and “salary.” It concluded, after doing so, that the term “wages and salary,” and therefore the term “earnings” in the top-hat plan, included only payment for services. Because the former executive’s severance pay was not for services, but was instead for her voluntary termination of employment, confidentiality, noncompetition, and waiver of claims against her former employer, the term could not be interpreted to include severance pay given to her for no longer working, even though that severance pay might be subject to federal income
tax. The court found this conclusion to be strengthened by the plan’s reference to “service earnings,” rather than simply “earnings,” when describing how benefits are to be calculated.


The Third Circuit interpreted a social security offset provision in a top hat pension plan in Ahearn v. Marsh & McLennan Companies, Inc., 124 Fed. Appx. 118, 34 EBC 2134 (3d Cir. 2005) (unpublished). The plaintiff retired at age 69 and began receiving social security benefits at that time, not at age 65 when he was first eligible for full social security retirement benefits. As a consequence, the executive’s monthly social security payments were higher than had he begun receiving payments at age 65. When the employer reduced the executive’s top hat SERP benefit by the actual monthly benefit, the executive argued that his offset should instead be the amount of his social security Primary Insurance Amount, which did not increase by reason of the executive’s delayed commencement of social security benefits.

The plan provided that, for participants retiring at age 65 or thereafter, the social security offset to be applied under the plan was the “estimated monthly primary Social Security benefit to which he is entitled at such time of retirement . . . .” The court reviewed the plan committee’s conclusion that the social security offset should reflect the increase in the executive’s monthly social security benefit resulting from the executive’s delayed commencement of those benefits. The court, citing its earlier decision in Goldstein v. Johnson & Johnson, 251 F.3d 433, 26 EBC 1193 (3d Cir. 2001), stated that top hat plans are “more akin to unilateral contracts than the trust-like structure normally found in ERISA plans,” and “[o]rdinary contract principles require that, where one party is granted discretion under the terms of the contract, that discretion must be exercised in good faith – a requirement that includes the duty to exercise the discretion reasonably.” The court ruled that the plan committee’s conclusion that the social security offset should take into account the increase in monthly benefit resulting from the executive’s delayed commencement of social security benefits was reached in good faith, and therefore should be upheld.

[New Heading] Offset for Employer’s Tax Liability

The First Circuit considered a nonqualified deferred compensation plan for non-employee insurance agents, under which benefit payments were reduced by the amount of a “tax liability offset,” in McAdams v. Massachusetts Mutual Life Insurance Company, 391 F.3d 287, 34 EBC 2863 (1st Cir. 2004). The court concluded that the plan permitted the insurance company to deduct an approximation of the insurance company’s tax liability associated with the accumulation of the agents’ deferred compensation. The plan gave the insurance company discretion to determine the earnings rate that would be credited on the deferred compensation. The company used that discretion to reduce earnings by the approximate tax burden to the insurer in holding the accumulated compensation and earnings. The company disclosed the reduction to agents and explained to them that they would enjoy no tax advantage under the program unless their tax rates were higher than the rate used by the insurer for the tax reduction.

[New Heading] California: Profit-based Incentives


In a striking decision, a California appeals court has concluded that an employer paying compensation based on net profits may not, in determining profits, take into account expenses which, under California law, may not be charged to an employee. Ralphs Grocery Company v. Superior Court, 112 Cal. App. 4th 1090, 5 Cal. Rptr. 3d 687 (Cal. Ct. App. 2003), review denied (Cal. 2/18/04). These would include deductions for any part of the cost of workers’ compensation claims (and, for employees other than certain executive and administrative employees, cash shortages, breakage, or loss of equipment, unless caused by a dishonest or willful act or the gross negligence of the employee). This prohibition on taking into account workers’ compensation costs means the normal calculation of net profits may not, under the court’s decision, be used even in calculating profit-based compensation for exempt employees.

[New Heading] New York Wage Statute: Forfeiture for Voluntary or “For Cause” Termination

The Court of Appeals of New York considered whether a forfeiture provision in a voluntary deferral program violated the provisions of New York Labor Law § 193 in Marsh v. Prudential Securities, 1 N.Y.3d 146, 802 N.E.2d 610, 770 N.Y.S.2d 271, 32 EBC 1401 (N.Y. 2003). The court issued its ruling in response to a certified question submitted by the Third Circuit. The state court was asked to consider a program under which financial advisors were permitted to voluntarily defer compensation. The deferred amounts were not credited with any interest earnings for the first three months after their deferral. Following the end of the three month period, the accumulated funds were used to purchase shares of an S&P 500 stock index fund, but with the purchase made at a 25 percent discount provided by Prudential (which managed the fund). The rough effect of this discount was to provide participants with a matching contribution equal to one-third of their deferrals.

The purchased shares were required to remain in a participant’s account for at least three years. If an employee were to voluntarily terminate employment or be terminated for cause during the three-year period, the employee’s plan balance was forfeited to the company. On expiration of the three-year period, a participant could renew his or her account or cash in the shares and pay income taxes on the proceeds.

The question certified to the court by the Third Circuit was as follows:

Whether New York Labor Law § 193 permits an employer, with an employee’s written and informed authorization, to enable that employee to defer wage taxes by making wage deductions and denying the employee any interest in those deducted wages for three months, and then investing the deducted wages in Standard & Poor’s 500–mirroring index fund shares that, while beneficially owned by the employee, are temporarily non-transferable and forfeitable to the employer if the employee quits or is terminated for cause.

Labor Law § 193 permits an employer to deduct a portion of an employee’s wages if the deduction is “expressly authorized” by and “for the benefit of the employee.” The statute authorizes the following specific categories of wage withholdings to which an employee may consent:
Payment for insurance premiums, pension or health and welfare benefits, contributions to charitable organizations, payments for United States bonds, payments for dues or assessments to a labor organization, and similar payments for the benefit of the employee.

(Emphasis added)

After examining the totality of the arrangement, including its advantages to employees, the relative sophistication of employees to which the arrangement was offered, and the communication to employees of the risk of forfeiture, the court concluded that the wage deductions qualified as “payments for the benefit of the employee” which were “similar” to the types of wage withholdings specifically authorized by the statute. The court held, therefore, that the plan did not violate the New York law.

[New Heading] Pennsylvania: Early Taxation

In a decision that has since effectively been overturned by legislation, the Commonwealth Court of Pennsylvania ruled that compensation employees have voluntarily deferred under unfunded nonqualified plans are subject to Pennsylvania income tax in the year earned – that is, in the year in which the services are performed – not when the amounts are paid following deferral. *Ignatz v. Commonwealth of Pennsylvania*, 849 A.2d 308 (Pa. Commw. Ct. 2004). Under *Ignatz*, taxation would occur in the earlier year because the amounts were constructively received at that time for purposes of Pennsylvania personal income tax, even though the language of Pennsylvania’s constructive receipt rule was virtually identical to the federal rule under Treasury Regulation § 1.451-2(a).

The Pennsylvania General Assembly overturned the ruling in *Ignatz* in House Bill 176, enacted in 2005. That bill generally adopts federal constructive receipt rules for purposes of applying Pennsylvania’s personal income tax. It had appeared that the result in *Ignatz* would be overturned by the Pennsylvania General Assembly a year earlier, in 2004. The Governor, however, vetoed that legislation on the stated ground that the statutory language could be applied more broadly than intended. 31 BPR 2708 (12/7/04). In 2004, in anticipation that the initial legislation would overturn the decision in *Ignatz*, the Pennsylvania Department of Revenue had withdrawn a policy notice regarding withholding requirements for elective deferrals under nonqualified deferred compensation arrangements. Pennsylvania Department of Revenue, Personal Income Tax Policy No. 112, withdrawn on January 5, 2005.

[New Heading] Top-Hat Plan: Definition

The Sixth Circuit, in determining whether to grant defendants’ summary judgment motion (and therefore taking plaintiff’s allegations as true), determined that a plan was not a top-hat plan where the plan covered employees with no supervisory, policymaking, or executive responsibilities. The plan, therefore, failed to satisfy the “selectivity” requirement of ERISA Section 201(2), that is, the requirement that top-hat plan be maintained primarily for a “select group of management or highly compensated employees.” *Bakri v. Venture Mfg. Co.*, 39 EBC 2340 (6th Cir. 2007). In analyzing whether the plan covered a select group of management or highly compensated employees, the court seemed to adopt the factors used by the federal district
court for the Northern District of Texas in *Carrabba v. Randalls Food Markets, Inc.*, 38 F.Supp.2d 468 (N.D. Tex. 1999), aff’d 252 F.3d 721 (5th Cir. 2001). This meant the court would, in determining whether the plan covered a select group, consider both qualitative and quantitative factors, including (1) the percentage of the total workforce invited to join the plan (quantitative), (2) the nature of their employment duties (qualitative), (3) the compensation disparity between top-hat plan members and non-members (qualitative), and (4) the actual language of the plan agreement (qualitative). The court also noted approvingly the *Carrabba* opinion’s conclusion that “the ‘select group’ test is whether the members of the group have positions with the employer of such influence that they can protect their retirement and deferred compensation expectations by direct negotiations with the employer.”

A federal district court found that an arrangement was not a top-hat plan, although it was still subject to ERISA and therefore state law claims were preempted, in *Guiragoss v. Khoury*, 444 F.Supp.2d 649, 39 EBC 1672 (E.D. Va. 2006). The deferred compensation arrangement was maintained by a small employer, with only 11 employees. At times only four of these 11 were not family members of the owners. The business operated jewelry retail stores and the plan covered at least two salespersons at those stores whose pay was in the middle of the company’s pay scale. At times, it appears, the plan covered three of the only four permanent, full-time employees. The plaintiff earned, on an annualized basis, about $33,000 when she became a participant in the program. The court said “from an objective standpoint,” $32,000 does not make an individual highly compensated for purposes of the top-hat rules. The court did not consider the salesperson to be a management employee, even though she may have had authority to open and close the store, which made her what the company termed a “key” employee.

The court, in explaining its conclusion, seemed to indicate that in determining whether than arrangement is a top-hat plan, the court will undertake a three part analysis. It will not only consider whether (1) the arrangement is unfunded, and (2) whether it is maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees, but will also apparently treat the Department of Labor’s analysis in Advisory Opinion 90-14A, in which the Department indicated that to be a top-hat plan employees participating in the arrangement must have sufficient influence within the company to negotiate compensation arrangements that will protect their own interests where ERISA provisions do not apply, as a third requirement separate from the second requirement above. As with the Sixth Circuit in *Bakri, supra*, the court seemed to approve of the “quantitative and qualitative” factor analysis set forth by the Northern District of Texas in *Carrabba*, citing that case with approval. As to the requirement under DOL Advisory Opinion 90-14A that the top-hat plan participants be in a position to protect their own interests, the court noted that a sales clerk would not have this clout, and this would be particularly true as to the plaintiff because she had been employed for less than one year when enrolled in the plan.

[New Heading] **Top-Hat Plan: Release/Fiduciary Claims/Estoppel**

A federal district court addressed the effect of a release on an executive’s claim for benefits under a top-hat plan in *Callahan v. Unisource Worldwide, Inc.*, 451 F.Supp.2d 428, 39 EBC 1556 (D. Conn. 2006). (See also, *Paneccasio v. Unisource Worldwide, Inc.*, 2006 WL 2128647, 38 EBC 2564, which involved the same plan and was decided by the same court.) The court held that a waiver by a sophisticated executive represented by counsel, which included a
waiver of ADEA claims, did not fail to be knowing and voluntary (and, therefore, was enforceable against the executive), where the release agreement promised to vest the executive in otherwise unvested split dollar life insurance nonqualified plan benefits and distribute those benefits “in accordance with the provisions of the Plan.” The executive complained about the amount of his benefits because the employer later terminated the plan and this resulted in substantially lower benefit payments than would otherwise have been the case. The executive claimed that an employer representative had told the executive that if he made the required life insurance premium payments, he would get the “benefits of the Plan” and the representative described those benefits without any reference to the reduction that would occur upon plan termination. The court relied on the language of the release to conclude that the release agreement promised only to vest the executive, and did not promise that he would avoid being subject to any benefit reduction that would apply in the event of plan termination. With respect to any oral promises which may have been made, the court noted that the release stated that the executive could not rely on representations or statements made by the employer or any employee with regard to the meaning or effect of the release.

The court also concluded that the executive’s ERISA fiduciary claim must fail because the parties seemed to have agreed that the arrangement was a top-hat plan and ERISA’s fiduciary rules do not apply to such arrangements. Finally, the court held that there were no extraordinary circumstances that would support the executive’s promissory estoppel claim, quoting the Second Circuit’s decision in Greifenberger v. Hartford Life Ins. Co., 131 Fed. Appx. 756 (2d Cir. 2005) to the effect that the extraordinary circumstances necessary to support an estoppel claim in the context of an ERISA plan would require conduct “tantamount to fraud.”


A federal district court concluded that a breach of fiduciary duty claim relating to a nonqualified deferred compensation plan would be untimely even if the plan were not a top hat plan (and therefore exempt from ERISA’s fiduciary rules) because the claim would fall outside ERISA’s six year statute of limitations for fiduciary claims. Bergmann v. BMC Industries, Inc., 2006 WL 487864, 37 EBC 1693 (D. Minn. 2006). The plaintiff-participants alleged that a breach of fiduciary duty occurred when the plan was announced, because at that time plan fiduciaries represented that the plan was funded and secured. The plan was, however, funded only through a “rabbi trust.” The company later filed for bankruptcy under Chapter 11 and the company rejected the nonqualified plan in that proceeding. The court concluded that the participants failed to make sufficient allegations of an ongoing fiduciary breach that would cause the statute of limitations to be measured from a date later than implementation of the plan. Integral to this conclusion was the lack of any obligation of the company to fund the plan, other than through the rabbi trust.


A company could not amend its top-hat plan to retroactively add an exhaustion of administrative remedies requirement after a lawsuit for benefits had been filed. Eastman Kodak Company v. STWB, Inc., 452 F.3d 215, 38 EBC 1098 (2d Cir. 2006). The top-hat arrangement had no claims and appeals procedure at the time the participant applied for benefits. The court
concluded that there was, therefore, a deemed denial of the participant’s claim, since there was no claims procedure, citing the Department of Labor’s claims and appeals regulations at 29 CFR § 2560.503-1(l). The employer was not, after the participant brought suit, permitted to add a claims and appeals procedure to the plan that would bind the plaintiff. The court reversed the federal district court, which had permitted the company to retroactively add an exhaustion of administrative remedies requirement on the theory that the amendment was permissible because it was “procedural” rather than “substantive.”

[New Heading] **Top-Hat Plan: Early Retirement Eligibility, Termination “With Consent”**

The Sixth Circuit considered a denial of early retirement benefits under a top-hat plan in *Simpson v. Mead Corp.*, 187 Fed. Appx. 481, 38 EBC 1176 (6th Cir. 2006) (unpublished). The executive appears to have been covered under a defined benefit nonqualified arrangement. His employment was involuntarily terminated at age 51 and he asserted that he was entitled to early retirement benefits under the arrangement. The court held that to be entitled to early retirement benefits on account of termination before age 55, the executive’s retirement must be “with written Company consent.” The court said that an involuntary termination is not a retirement with written Company consent because although the company terminated the executive, it did not give consent to his early retirement.


A deferred compensation program was determined to be a “top hat” plan, and the benefit claims of plan participants were general unsecured claims against the employer which had filed a voluntary petition under Chapter 11 of the Bankruptcy Code, in *In re IT Group, Inc.*, 305 BR 402, 32 EBC 2906 (Bankr. D. Del. 2004), aff’d, 323 BR 578, 35 EBC 1413 (D. Del. 2005). The court rather easily concluded that the arrangement was unfunded, as necessary for the arrangement to constitute a top hat plan. The plan document included typical top hat language, indicating that the plan was unfunded and that payments were to be made from the general, unrestricted assets of the employer. A trust agreement establishing a rabbi trust was apparently executed, but the trust was not funded. The court noted that even if the rabbi trust had been funded, that would not have caused the arrangement to have been funded so as to cause the arrangement to lose top hat status.

The plaintiffs argued that one of them had been told by the company’s president and CEO that the plan was a funded arrangement and that in the event of the company’s insolvency the rabbi trust would be funded and the amounts owed to participants would be paid in full. The court held that parol evidence, such as oral representations, would not be admissible because the plan was unambiguous concerning its funded status (and the plan included an integration clause).

The bankruptcy court’s decision was affirmed in *Accardi v. IT Corp. (In re IT Group Inc.*), 2005 WL 742879 (D. Del. 2005). In affirming the decision, the district court rejected the executives’ argument that (a) the plan committee had a duty of good faith and fair dealing to order funding of the plan when it appeared the debtor-employer was on the verge of insolvency, and (b) the court should therefore consider the plan funded (and not a top hat plan under which the executives were general unsecured creditors of the employer). In reaching its conclusion, the court noted that the rabbi trust’s express provisions made the trust assets subject to the
employer’s general creditors, and concluded that because the rabbi trust was the only trust created under the plan, the only discretion afforded to the committee was to set aside monies in that trust.

The plaintiffs then appealed from the district court decision on one issue – whether the arrangement was unfunded. In re IT Group, Inc., 448 F.3d 661 (3d. Cir. 2006). The plaintiffs, of course, argued that the arrangement was funded, so it was not a top-hat plan and they could proceed with their claims under ERISA. The Third Circuit’s analysis was very similar to that of the bankruptcy court in its initial decision. In getting to the same conclusion as the bankruptcy court, the court surveyed cases decided by the Second, Fifth, and Eighth Circuit Courts of Appeal concerning what constitutes an unfunded arrangement for purposes of determining whether an arrangement was a top-hat plan exempt from ERISA’s funding and fiduciary requirements. After doing so, the Third Circuit came to its own formulation for determining whether an arrangement is unfunded, synthesizing principles from the other circuit courts of appeal. The court stated its rule as follows:

We agree with our fellow courts of appeals that the keys to the determination of whether a plan is “funded” or “unfunded” under ERISA are (1) whether beneficiaries of the plan can look to a res separate from the general assets of the corporation to satisfy their claims; (2) whether beneficiaries of the plan have a legal right greater than that of general, unsecured creditors to the assets of the corporation or to some specific subset of corporation assets. We may also consider the plan’s intended and actual tax treatment.

448 F.3d at 669. The reference to the plan’s tax treatment appears to have been a reference to the Fifth Circuit’s statement in Reliable Home Health Care, Inc. v. Union Central Insurance Co., 295 F.3d 505, 514, that a “plan is more likely than not to be regarded as unfunded if the beneficiaries under the plan do not incur tax liability during the year that the contributions to the plan are made.” (Quoting Miller v. Heller, 915 F.Supp. 651, 659 (S.D. N.Y. 1996)).

[New Heading] Earnings: Net Losses

In a rather straightforward decision, an employer was required to pay interest on contributions made to a nonqualified defined contribution plan at a rate of four percent per year, as the relevant agreement provided, even though the plan contributions had been invested by the employer and, in fact, suffered net losses. Huizenga v. American International Automobile Dealers Association, 2005 WL 3132451, 36 EBC 2435 (E.D. Va. 2005).

[New Heading] Oral Promise: ERISA Fiduciary Claim, Equitable Relief

In Eastom v. Redmond, 2006 WL 2380782, 39 EBC 1984 (N.D. Ind. 2006), a former employee alleged that his now-bankrupt employer had promised him supplemental retirement benefits at the time the employer terminated its qualified defined benefit pension plan (and that it made a similar promise to guarantee certain other benefits to two other employees as well). The employer allegedly purchased two life insurance policies to fund this promise. It is unclear from the opinion what ultimately happened to those policies, but it seems apparent that the former employee argued that he did not receive the promised benefits, and in particular did not receive...
the benefit of the funding provided by those policies. The former employee brought claims for breach of fiduciary duties under ERISA against two former board members and the company’s former chief officer, apparently for failing to preserve the insurance policies or at least failing to provide that the proceeds of those policies would benefit the former employee. The former employee made claims under both Sections 502(a)(2) and 502(a)(3) of ERISA. The court found that there was no 502(a)(2) claim because the former employee was seeking individual relief, even though the former employee argued that because he was the only remaining participant in an informal “plan,” the relief he would enjoy would effectively be plan-wide relief. The court also concluded that the 502(a)(3) claim failed because the former employee was seeking legal relief, not equitable relief, within the meaning of the Supreme Court’s precedent in Great West Life & Annuity Insurance Co. v. Knudson, 534 U.S. 204, 27 EBC 1065 (2002) and Sereboff v. Mid Atlantic Medical Services, Inc., 126 Sup. Ct. 1869, 37 EBC 1929 (2006). That was because the former employee failed to ascertain whether the defendants had control of the insurance policies, and therefore could not adequately allege that the defendants were in possession of property which could be the subject of equitable relief. The court did not discuss whether the arrangement was a top-hat plan or whether the fiduciary rules should apply at all.

Securities Fraud

In Abbad v. Amman, 112 Fed. Appx. 97, 2004 WL 2292371, (2d Cir. 10/11/04) (unpublished), plaintiffs alleged that executives’ employment agreements improperly tied the executives’ bonuses to the successful sale of the company’s assets, and argued that this gave the executives an incentive to dismantle the company and sell off its assets, which in turn caused the price of the company’s stock to collapse. The Second Circuit found these allegations to be inadequate to state a claim for violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The court concluded that the structure of the executives’ compensation arrangement was insufficient to show an intent to defraud, in part because the agreements guaranteed the same bonus in the event of either a successful restructuring or a sale of the company’s assets. While the employment agreements did not discourage executives from selling the company’s assets instead of restructuring, they gave the executives no more incentive to sell than to restructure.

The Ninth Circuit considered whether state securities fraud claims were preempted by the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) in Falkowski v. Ination Corp., 309 F.3d 1123, 29 EBC 2267 (9th Cir. 2002), opinion amended, 320 F.3d 905 (9th Cir. 2003). The court concluded that a grant of options was a sale of securities under SLUSA, if the stock to which the options related were covered securities under that Act. Because the grant was a sale of securities under SLUSA, state fraud claims relating to the option grant were preempted. The court, in concluding that the option grant was a sale under the securities laws (as a contract to sell a security when the option is exercised), rejected the contrary holding of In re Cendant Corp. Securities Litigation, 76 F.Supp.2d 539, 545 (D. N.J. 1999).

A federal trial court held that the former chairman of the board of a corporation stated a claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 where he alleged that the employer falsely denied the existence of an imminent merger when negotiating a severance agreement that provided for the sale of the chairman’s stock to the corporation. Rizzo v. The MacManus Group, Inc., 158 F.Supp.2d 297, 25 EBC 2675 (S.D. N.Y. 2001).
The court in Sedaghatpour v. DoubleClick Inc., 213 F.Supp.2d 367, 29 EBC 1070 (S.D. N.Y. 2002), considered when the statute of limitations would begin to run for securities fraud purposes with respect to a dispute over the vesting of stock options. The court concluded that the limitations period for purposes of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 began to run when an employee received a post-hire letter stating that his options would vest incrementally, where the employee indicated this contradicted an oral pre-hire representation that the options were “indefeasible.”

The Supreme Court concluded that a stock option was a “security” for purposes of Rule 10b-5 in Wharf (Holdings) Ltd. v. United International Holdings, Inc., 532 U.S. 588, 121 S. Ct. 1776 (2001). The fact that the option was granted pursuant to an oral promise, rather than a written agreement, did not preclude the plaintiff from raising a Rule 10b-5 claim. The plaintiff was the operator of cable television systems who sued the licensee of a Hong Kong cable television system and its managing director, alleging that the licensee violated Rule 10b-5 by selling the operator an option to purchase 10 percent of the stock in the cable system with a secret intention not to honor the option. The Supreme Court concluded that the sale of an option with a secret intention not to honor it would constitute a violation of Rule 10b-5.

[New Heading] Extraordinary Payments Under Sarbanes-Oxley Act

The Ninth Circuit found that a payment to a company’s terminated CEO and CFO of approximately $37 million, plus six million shares of stock, were “extraordinary payments” under the Sarbanes-Oxley Act, so as to warrant the escrow of those monies during an SEC investigation for fraud and overstating company revenues. Securities & Exchange Commission v. Gemstar-TV Guide International, Inc., 401 F.3d 1031, 35 EBC 1683 (9th Cir. 2005), cert. denied, 126 S. Ct. 416, 36 EBC 2824 (2005). Section 1103 of the Sarbanes-Oxley Act gives the SEC authority to ensure that assets of an issuer of publicly traded securities are not dissipated during the investigation and litigation of cases involving possible violations of the federal securities laws. The SEC is, however, able to require the escrow of such payments only if they are extraordinary.

The court concluded that the term “extraordinary” describes payments that typically would not have been made by a company in its customary course of business. Applying this standard, the court determined that the payments in question were extraordinary. The court explained that the determination of whether a payment is extraordinary will be a fact-based and flexible inquiry. Factors such as the circumstances under which the payment is contemplated or made, the purpose of the payment, and the size of the payment may inform whether a payment is extraordinary. A nexus between the suspected wrongdoing and the payment itself may support an argument that a payment is extraordinary, although such a connection is not necessary. A company’s deviation from compensation “industry standards” – or the practice of similarly situated businesses – also is indicative that a payment is extraordinary.

Among the factors the court found persuasive in concluding that the payments were extraordinary were that (a) the payments were negotiated over a five-month period and involved the participation of the board, a special committee, and outside consultants, (b) the recipients of the compensation were each represented by separate sets of counsel, (c) the termination agreements providing for the compensation were executed as part of a process of removing the
executives from their positions, (d) the payments were five to six times greater than the executives’ base salary, (e) the component amounts that made up lump sum payments were different than the amounts due under the executives’ employment agreements, (f) termination fees were different from what the executives may have been entitled to under existing agreements, (g) bonuses appeared to result from the alleged fraudulent financial results, and (h) vacation pay was provided that did not exist under the executives’ employment agreements. As the court said, “[o]ne would not expect benefits like these to be flowing from corporate assets to executives resigning under fire from key management positions.” Notably, the court also found support for its conclusion that the payments were extraordinary from the executives’ refusal to cooperate with the SEC. The court said “[t]elling also is the glaring fact that [the CEO] would not discuss these matters with the Commission, choosing instead to assert his Fifth Amendment privilege.” The court cited an earlier Ninth Circuit decision for the proposition that “parties are free to invoke the Fifth Amendment in civil cases, but the court is equally free to draw adverse inferences from their failure of proof.” SEC v. Colello, 139 F.3d 674, 677 (9th Cir. 1998).

**Stock Options**

[New Heading] *Contractual Waiver of Fiduciary Duty*

An executive waived any duty by his employer to disclose, at the time the executive was preparing to retire and exercise his stock options, the impending announcement of an initial public offering. The executive retired while the company was still privately held. The executive had, however, prior to retirement discussed with the company’s benefits director the possibility of the company going public. Upon the executive’s retirement, the employer exercised its right under a stockholders’ agreement to repurchase the executive’s shares at the stock’s most recent appraisal price. The company called the executive’s stock about a month prior to announcing its initial public offering. The IPO resulted in the value of the company stock more than doubling. The court concluded that the company owed the executive no duty to disclose future events which could impact the value of the executive’s shares, despite the company’s fiduciary obligation to the executive under Delaware law, because those duties were amendable by contract and the executive had agreed in the stockholder’s agreement that the company had no obligation to disclose any event or transaction that may have occurred or be proposed or pending at the time of the appraisal of the stock to be purchased. Houston v. Aramark Corporation, 2004 WL 2203981 (3d Cir. 2004) (unpublished).

[New Heading] *Lockup Agreement: Misrepresentation*

Two independent contractors, one of whom received stock options and the other of whom received stock as compensation for services to a company, brought claims for fraud and negligent misrepresentation against the company. The parties alleged they had been told they must execute lockup agreements because the company wished to make an initial public offering, and alleged they were told that all shareholders and optionholders would be required to execute such agreements. Following the IPO, the company’s share value quickly ascended to $100. It fell to $17.75 by the end of the lockup period, and was in the $1 to $2 range when the participants exercised or sold their shares. The plaintiffs learned after the fact that other shareholders had not executed lockup agreements and that some had, in fact, sold stock or exercised options at more favorable prices than the initial post-lockup value.
The court rejected the plaintiffs’ fraud and negligent misrepresentation claims because even if the plaintiffs were owed a duty of reasonable care in conveying information to them, they could not have reasonably relied on the alleged misrepresentations. The written lockup agreements included express provisions allowing the underwriter to “waive any provision of this Lockup Agreement without notice to any third party.” The court found that neither plaintiff could have reasonably relied on statements that were to the contrary of the express provisions of the written agreement.

One of the plaintiffs also brought a breach of contract claim. That plaintiff claimed he originally provided services in exchange for an oral promise of stock options, which was later replaced by written agreements. Some of the terms of the written agreements allegedly differed from the terms of the oral promise, but the plaintiff nevertheless signed the written agreements. The plaintiff argued that the written option agreements constituted a breach of the oral agreement because they contained restrictions concerning when the plaintiff could sell stock following the exercise of his options. The court rejected this claim, concluding that the written agreements superseded any alleged oral contract and therefore controlled the terms of the grant. *Syverson v. Firepond, Inc.*, 383 F.3d 745 (8th Cir. 2004), reh’g and reh’g en banc denied (2004).

[New Heading] *Misrepresentation: Reasonable Reliance*

The Supreme Court of Delaware remanded to a state appellate court a matter involving a former CEO’s claims for fraud and negligent misrepresentation relating to the exercise date for certain stock options. The state appellate court had concluded that the former CEO’s reliance on his employer’s alleged misrepresentations concerning the exercise date was unreasonable as a matter of law. The Supreme Court of Delaware disagreed, remanding the matter for a trial on the reasonableness of the former CEO’s reliance. The CEO, upon retirement, had inquired about his severance package and stock options. The employer’s general counsel checked with the human resources manager and reported – incorrectly, as it turned out – that the CEO would have three to five years to exercise his options. The employer’s stock option administrator sent the CEO a summary which also included this inaccurate information. Later quarterly summaries sent to the former CEO showed the correct exercise dates, but the CEO did not review those summaries. Only after the exercise deadline had passed did the former CEO learn that the options had expired and, he alleged, suffer a loss in excess of $5 million by reason the options’ expiration. *Vague v. Bank One Corporation*, 850 A.2d 303, 2004 WL 1202043 (Del. 2004) (table).

[New Heading] *Misrepresentation: Time Limit for Exercise*

The Third Circuit rejected former executives’ state law claims that in-house counsel for their former employer breached his fiduciary duty to the executives and engaged in the negligent misrepresentation of material facts regarding the time limit for exercising the executives’ stock options following their termination of employment. *Dinger v. Allfirst Financial, Inc.*, 82 Fed. Appx. 261, 31 EBC 2230 (3rd Cir. 2003) (unpublished). The employer’s stock option plan provided that options would be exercisable for three months from the date of a participant’s “cessation of employment.” The company’s board of directors agreed to merge the company with another organization and the plaintiffs, fearing the loss of their jobs following the merger, asked the company’s in-house counsel about the deadline for exercising their options. In-house counsel advised the executives that they were required to exercise their options within three
months “from the date of cessation of employment,” and that this would include a termination resulting from a change in corporate control such as the impending merger. The executives resigned and exercised their options within the designated timeframe. Under the terms of their severance agreements, the executives continued to receive compensation and certain benefits for a period of two years following their last date of active employment. The company’s merger partner concluded, following the executives’ resignations, that the three-month timeframe for exercising options would be measured from the expiration of the two-year period during which these (and other) employees were to receive severance compensation and benefits.

The executives filed suit, claiming the employer owed them a fiduciary duty to act with good faith and fair dealing, and that this duty was breached when in-house counsel provided faulty advice concerning their stock options. The executives seemed to claim that but for the misinformation from in-house counsel, they would have exercised at least some of their options on a later date when the bargain element would have been greater. The court concluded that in-house counsel had not provided “false information” to the executives. In-house counsel’s interpretation of the stock option provisions had been based on the plain plan language and the company’s past practice. A more generous interpretation by the company’s merger partner did not, according to the court, make the original interpretation untrue.

There was no misrepresentation allowing an extension of time for exercising options where any erroneous oral statement concerning the deadline for exercise was negated by later option summary reports bearing the correct deadline. Vague v. Bank One Corporation, 2006 WL 290299 (Del. Ch. 2006) (unpublished). The executive who brought suit did not read the later reports, instead forwarding them to his accountant who himself failed to note the relevant deadlines. The court concluded that the executive was not justified in failing to read the reports.

A former executive’s claim for negligent misrepresentation concerning the time for exercise of incentive stock options upon termination of employment survived a motion for summary judgment in FirstMarblehead Corp., 473 F.3d 1 (1st Cir. 2006). The stock option plan provided for options with a ten year term. Participants were, however, required to exercise within three months of their termination of employment. The plaintiff had been informed of the ten year term, but not the three month deadline for exercise upon termination. There was evidence that the employer knew it should have disclosed the three month exercise deadline to the executive, and evidence that it knew that it had failed to do so. The former executive’s breach of contract claims and promissory estoppel claims for an extended exercise period failed because, under Delaware law (Del. Code Ann. tit. 8, § 157(a)), the terms of any stock option plan or agreement must be followed despite any representations made to a participant contradicting those terms, except possibly for minor extensions of the exercise period under the authority of Ostler v. Codman Research Group, Inc., 241 F.3d 91 (1st Cir. 2001). Although, under Ostler, a minor delay in the extension period for options may be permissible, the delay requested by the plaintiff would have been for a period of several years and was therefore not minor.

The court refused to dismiss at the summary judgment stage the former executive’s claim for negligent misrepresentation. Although the stock option plan had a choice of law provision which caused the court to apply Delaware law to the breach of contract and promissory estoppel claims, the court instead applied Massachusetts law with respect to the former executive’s negligent misrepresentation claim. Delaware law applied to the breach of contract and
promissory estoppel claims because the choice of law provisions stated that the plan’s provisions “shall be governed by and interpreted in accordance with” Delaware law, and the provisions of the plan were central to the contract and promissory estoppel claims. In contrast, the court held that no similar agreement governed the negligent misrepresentation claim, presumably because it did not seek benefits under the plan, but instead stood as a claim outside of the plan. Applying choice of law provisions under the Restatement (Second) of Conflict of Laws (1971), the court found that all the relevant contacts were in Massachusetts. In particular, the employer’s principle place of business was in Massachusetts, the misrepresentations were made in, received, and relied upon in Massachusetts, and the former executive was a Massachusetts resident. Under Massachusetts law, the former executive’s negligent misrepresentation claim could be based on a failure to disclose, not just an affirmative misrepresentation. The former executive’s claim survived the company’s motion for summary judgment because there was testimony that the company had notice regarding its failure to disclose an important term of the options (the three month exercise deadline) and the company acknowledged its failure to disclose that information. This was “more than sufficient” to raise a genuine issue of material fact regarding negligent misrepresentation through failure to disclosure. Although it was clear that the former executive had an understanding of the financial aspects of stock options, it was less than clear that he understood the technical issues relating to incentive stock options and, in particular, the possible need to exercise quickly following termination.

[New Heading] Stock Sale: Time Limit for Exercise

Employees of a subsidiary were, for purposes of the deadline for exercising options, treated as terminated upon the sale of the subsidiary’s stock. *Falkowski v. Imation Corp.*, 132 Cal. App. 4th 499 (Cal. App. 2005), reh’g denied, review denied (2005), on remand from, 320 F.3d 905 (9th Cir. 2003). As a result, the employees were required to exercise their options within 30 days of the sale. The options’ terms had previously been amended upon the parent’s earlier acquisition of the subsidiary, to provide that a participant would cease to be an employee for the purpose of the options when he or she was no longer an employee of the parent company or a subsidiary of the parent. Upon the sale of the subsidiary’s stock, the employees’ employer was, of course, no longer a subsidiary of the former parent. As a result, the participants were no longer employees and were therefore required to exercise their options within 30 days.

In its analysis, the court considered the terms of the options to be ambiguous concerning whether sale of the subsidiary’s stock would constitute a termination of employment accelerating the deadline for exercising options. It concluded, however, that the sale did constitute such a termination in part because this interpretation was more consistent with the stock option plans’ articulated goals of (1) attracting good employees, (2) encouraging the employees to remain with the company, and (3) rewarding their hard work. Continuing the employees’ options after the sale would not serve these goals because the court interpreted these as goals of the parent company, not the subsidiary.

The court enforced the same 30 day deadline following termination of employment for the exercise of options under a separate stock option plan, even though the plan referred only to termination of employment, and not to termination of employment with the company, where (a) a letter from the CEO accompanying the stock option grants referred to termination of employment with the parent, (b) the term “participant” was defined as an employee of the parent
or an affiliate, and (c) doing so was more consistent with the plan’s goals (which were the same as he goals described above for the other plans).

[New Heading]  *Termination of Employment: Cancellation at Administrator’s Discretion*

A federal district court concluded that a stock option plan did not, by its terms, cancel options on termination of employment. Instead, the plan gave the plan administrator the *power* to set the terms for termination of the options. The court concluded that there was a genuine issue of material fact as to whether the administrator had in fact acted to terminate the options on termination of employment. The only evidence that the administrator had done so was a letter from the company’s general counsel. *Lucius v. Micro General Corporation*, 33 EBC 1324, 2004 WL 1598813 (N.D. Ga. 4/5/04).

[New Heading]  *Attorneys’ Fees: Preliminary Injunction During Pendency of Arbitration*

A federal district court denied a former CEO’s request for a preliminary injunction requiring that the CEO’s former employer pay the executive’s attorneys’ fees during the pendency of an arbitration proceeding concerning the CEO’s stock options and termination benefits. The CEO’s employment agreement required that the employer pay the former executive’s attorneys’ fees to the extent those fees exceeded $15,000. The court denied the preliminary injunction because the executive could not show irreparable harm, since there was inadequate proof that the employer might fail financially or that the former executive could not afford to front his own attorneys’ fees. *Clouser v. Ion Beam Applications, Inc.*, 2004 WL 540514 (N. D. Cal. 2004).

[New Heading]  *Waiver of Other Benefits*

Following a merger, Pioneer Hi-Bred International, Inc. became a subsidiary of E. I. DuPont Nemours and Co. Prior to the merger, Pioneer adopted a change in control severance plan providing protection to executives in the event of an involuntary termination of employment. Involuntary termination included a resignation or retirement for “stated good reason.” Class action litigation ensued following the merger. The class action was intended to resolve a number of issues under the change in control plan. Defendants under the class action sought permission from the court to present a retention proposal to all of the change in control plan participants, which the court granted. Under the retention agreement, DuPont agreed to provide stock options in exchange for a waiver of benefits under Pioneer’s severance plan. The plaintiff in the current action was suspicious of the retention agreement and retained legal counsel for the purpose of discussing the proposal. The executive, however, ultimately signed the agreement, but later sued DuPont asserting that requiring her to sign the agreement and waive her right to severance pay violated ERISA. The court found that the executive knowingly and willingly signed the retention agreement and therefore was barred from pursuing a claim for severance benefits. *Martino-Catt v. E. I. DuPont Nemours and Co.*, No. 4:02-CV-90500 (S.D. Ia. April 29, 2004).

[New Heading]  *Appraisal Right*

The Court of Chancery of Delaware rejected an action by optionholders seeking appraisal under Delaware’s statutory appraisal provision of the value of shares and options they owned in
a corporation before it was merged. *Andaloro v. PFPC Worldwide, Inc.*, 830 A.2d 1232 (Del. Ch. 2003). The optionholders, who were executives in the corporation prior to its merger, argued that they could seek appraisal under 8 Del. C. § 262 to receive the “fair value” of the options they were forced to give up in the merger in exchange for certain other consideration. The executives argued that the company failed to provide them with adequate information or otherwise make fair provision for them to convert their options into stock before the effective time of the merger, despite the fact that under the relevant option agreements the executives’ options were to vest upon the occurrence of a change of control, including a short-form merger under 8 Del. C. § 253 (which was the form of the transaction at issue). The executives offered evidence that the company’s board did not undertake a fair valuation process for the options but simply imposed a take-it-or-leave-it value on the executives in an offer that required the executives to waive certain legal rights.

The court concluded that Delaware’s right of appraisal under Section 242 is available only to shareholders, and not to optionholders. The court did note, however, that the executives might nonetheless be successful on equitable or contractual claims regarding the treatment of their options, and that the resulting remedy might well be an award of damages equal to a judicial assessment of the fair value of the options lost.

**[New Heading] Termination for Cause: Good Faith Requirement**

The U.S. District Court for the Northern District of Illinois applied California law to conclude that an employer’s determination that an executive’s employment was terminated “for cause” – and therefore that the executive had no right to exercise stock options following that termination – must be made in good faith. *Hanekamp v. McKesson Corp*, 31 EBC 1482, 2003 WL 21360808 (N.D. Ill. 2003). Notably, the executive appears to have been an at-will employee with no written contract of employment. The court nevertheless considered the employer’s stock option program to constitute a contract to which California’s implied covenant of good faith and fair dealing applied. The court cited a California Supreme Court decision setting out factors for determining “good cause” for terminating an employee for misconduct when an implied employment contract exists. In that decision, *Cotran v. Rollins Hudig Hall Int’l, Inc.*, 948 P.2d 412 (Cal. 1998), *reh’g denied* (Feb. 25, 1998), the California Supreme Court interpreted the term “good cause” to mean:

fair and honest reasons, regulated by good faith on the part of the employer, that are not trivial, arbitrary or capricious, unrelated to business needs or goals, or pretextual. A reasoned to conclusion, in short, supported by substantial evidence gathered through an adequate investigation that includes notice of the claimed misconduct and a chance for the employee to respond.

Emphasizing the need for proper process when determining whether an executive was terminated for good cause, the court also noted the California Supreme Court’s decision in *Silva v. Lucky Stores, Inc.*, 65 Cal. App. 4th 256, 76 Cal. Rptr. 2d 382 (1998) (“three factual determinations are relevant to the question of employer liability: (1) did the employer act with good faith in making the decision to terminate; (2) did the decision follow an investigation that
was appropriate under the circumstances; and (3) did the employer have reasonable grounds for believing the employee had engaged in misconduct.”).

[New Heading] Improper Delegation of Claim Decision

The Tenth Circuit, in considering an employee’s claim for accelerated vesting of stock options, concluded that the employer’s compensation committee, which under the plan terms had “plenary authority” to make “final and binding” decisions concerning plan interpretation, had improperly allowed a vice president of human resource to decide the employee’s claim for accelerated vesting. *Mauldin v. WorldCom, Inc.*, 263 F.3d 1205, 26 EBC 2378 (10th Cir. 2001). The court found no evidence that the committee had properly delegated to the vice president authority to determine claims, nor had it properly ratified the vice president’s denial of the employee’s claim. Although the committee had “ratified and approved the prior appointment of, and delegation of the committee’s authority to,” the vice president, the court required more for a proper delegation or ratification. In part, the committee’s action failed as a proper delegation because it occurred after the claim denial. The committee’s purported ratification was ineffective because the court concluded that to properly ratify an agent’s stock option vesting decisions, the committee would need to be at least minimally aware of the material facts, such as the vesting decisions made by the agent and the agent’s basis for making them. The minutes of the committee’s meeting at which it ratified the vice president’s conduct did not indicate that the committee was even aware of the particular claim at issue, much less knew any of the facts underlying the claim.

Importantly, the court acknowledged that the committee may impliedly delegate its authority. The employer had not, however, argued that the committee had done so. The court, in discussing the possibility of implied delegation, stated as follows:

[The employer] has also failed to establish an implied delegation of authority to [the vice president]. This would not be a difficult argument to make, for common sense dictates that:

With a Fortune 500 Company . . . it is necessary that many different and varying functions and duties be delegated to officers and employees of the corporation in order that the operation of the corporation may be conducted in a continuous, systematic and profitable manner. This often involves giving wide latitude and discretion to corporate personnel. To require that a company . . . draft a corporation resolution authorizing its personnel to make everyday decisions regarding the conduct of the corporation’s affairs would be to place unduly burdensome restrictions on a large corporation . . . .

*Karam v. Travelers Ins. Co.*, 813 F.2d 751, 753 (5th Cir. 1987) (quoting opinion below). However, [the employer] does not argue in its brief that the Committee had impliedly delegated authority to [the vice president], although such an argument, coupled with a
more complete record in support, might have been persuasive. Thus, [the employer] has waived this argument, Gaines-Tabb v. ICI Explosives, USA, Inc., 160 F.3d 613, 624 (10th Cir. 1998), and has failed to show that [the employer’s] Compensation Committee adequately delegated authority to [the vice president] to decide [the former employee’s] request.

For a case in which a court found an implied delegation of authority, see Medtronic, Inc. v. Wohlfeld, 2002 WL 523873 (D. Minn. 2002) (CEO and internal stock committee impliedly delegated to Director of Shareholder Services authority to exercise stock buy-back rights, where employee went to work for competitor within six months of exercising options under which shares were purchased).

[New Heading] Oral Grant of Options

A federal trial court held that oral promises made by executives ensuring a former employee that he could exercise his vested stock options following his termination of employment were not enforceable. Mucci v. Home Depot, 2001 WL 1609851, 27 EBC 1765 (E.D. Pa. 2001). The court found the plan to be clear that participants terminated for “cause” forfeited their right to exercise options, despite the former employee’s claim that he had been told he would have 90 days following termination to exercise his options. The claimed oral statements could not themselves give rise to a contract because the former employee, who was an at-will employee, provided no consideration for any modification in the stock option terms.

In an unreported decision, a California Court of Appeals held that a former executive could enforce a CEO’s promise that the executive would be “kept whole” with respect to a stock option program if the executive were to move his employment to a new (unrelated) company. Reeb v. Airtouch Communications, Inc., 31 EBC 2654, 2003 WL 22345723 (Cal. App. 2 Dist. 2003) (unpublished). The court concluded that the CEO’s promise was not barred by the statute of frauds because it could be performed within one year – for example, if the executive’s employment were terminated during that timeframe.

The executive had been recruited to the new company to set up a human resources department, but had been concerned about losing stock options under his current employer’s program. The new company did not have a similar program in place at the time and the executive, therefore, asked whether such a plan would be instituted and whether it would equate with his current employer’s program. After being urged to sign a “Secondment Agreement” regarding his employment with the new company, which provided he would no longer participate in his prior employer’s stock option program, the executive was assured that the new company’s new program would be as good as the prior plan – that is, that he would be “kept whole” and would “not lose out” by going to the new company. The program ultimately developed by the new company, however, was a cash based, not stock based, plan, and set a cap on benefits. Later, when the old employer merged with another company, the value of the old employer’s stock skyrocketed. Following a further merger, the executive was sent a letter informing him that his position would be eliminated in two months. (The executive apparently had remained a common law employee of the old employer, although he provided his services to the new company.) The executive obtained a position with another employer during the interim,
but before he could inform his employer of this fact, he was advised that his position would not be eliminated after all. Because a voluntary departure would cause the executive to lose severance benefits, he asked that his employer honor its earlier letter announcing the executive’s termination. The employer refused and failed to pay the severance benefits.

The court upheld a jury verdict awarding $3.8 million to the former executive on his claim for stock option compensation, and affirmed a bench decision awarding the executive $120,000 in severance pay on his ERISA claim. In addition to concluding that the executive could enforce the CEO’s promise that he would be “kept whole” with respect to the stock option program, and that the executive’s claim was not barred by the statute of frauds, the court concluded that California’s two year statute of limitations for oral contracts did not begin to run until the time the old employer’s plan would have provided greater benefits than the benefits payable under the new company’s plan. This occurred only when the value of the old employer’s stock increased to a level that caused the value of options under the old employer’s plan to exceed benefits under the new employer’s program. The court went on to conclude that the parol evidence rule did not exclude evidence of the CEO’s oral promise because the “keep whole” agreement was not an agreement that would naturally have been a part of the secondment employment agreement. Finally, the court concluded that, for purposes of the company’s severance program, the executive’s employment was terminated involuntarily when he received notice of his termination, even though that termination was later “rescinded” prior to the date the employer said the executive’s employment would terminate.

A federal district court rejected an executive’s argument that there was an enforceable oral contract to grant stock options in Aretakis v. General Signal, Inc., 2006 WL 1581781, 38 EBC 1668 (D. Mass. 2006). Aretakis involved an attempt to recruit an executive to a subsidiary of a company. During the recruitment process, the president of the subsidiary, as well as the vice president of human resources, discussed with the plaintiff in early 1997 a planned spinoff of the subsidiary and IPO, and allegedly indicated the president planned for the top eight members of the subsidiary’s management team each to be granted options to acquire 5/8ths of one percent of the equity in this spunoff company. The president allegedly indicated that he expected the business unit would be spunoff before the end of the summer of 1997. The president further allegedly indicated that the plaintiff would be one of those who would receive such an equity interest. The plaintiff understood from the president that her options would vest over a four year period from the inception of the spinoff, which she understood to mean that she would have the option to buy one quarter of her 5/8ths of one percent of the company’s stock at the end of each year. The president allegedly told the executive that the share price after the IPO was issued might be roughly $20, and that her strike price under her options would be in the neighborhood of $10. The president did, however, indicate that these were just estimates but whatever the actual prices turned out to be, there would be a fairly reasonable spread between the strike price and the stock price.

The executive entered into an at-will employment arrangement. Letters to the executive describing her compensation did not mention any stock ownership. The spinoff was delayed and did not occur for several years. By the time the spinoff occurred, the executive had left the company. She sued, complaining about the spinoff not having occurred earlier and, as a result, her not having received her equity interest.
The court rejected the executive’s oral contract argument because it found the promise to be too indefinite since there was uncertainty as to the strike price and the date of the spinoff and IPO. In addition, the court found that the president’s comments had only been expressive of a present intention to provide equity ownership, so there could have been no contract. The court rejected the executive’s promissory estoppel argument because her reliance was unreasonable since the president had only described to the executive his expectations, and the executive knew that there were contingencies, such as the need for approval of the transaction by the parent company’s board of directors, as well as approval from the IRS. The court also held that there could be no recovery under the Massachusetts Unfair or Deceptive Practices Act because matters involving the hiring and firing of employees do not involve the requisite commercial transaction required to implicate that statute. Finally, there was no fraud because the executive had no reasonable reliance and there was no evidence that the president’s statements were knowingly false.

[New Heading] Determining Date of Employment Termination

The Ninth Circuit held that a compensation committee could properly conclude that a Swiss employee ceased to be employed for purposes of a stock option plan on the date the employer said the executive was terminated (a date as of which the executive no longer provided services), even though under Swiss law (which governed the executive’s employment contract) the executive was still employed. Notably, the stock option plan included a California choice of law provision and granted discretion to the compensation committee to decide when an individual ceased to be employed. Oracle Corp. v. Falotti, 319 F.3d 1106, 29 EBC 2687 (9th Cir. 2003), cert. denied 124 S. Ct. 225, 31 EBC 2760 (2003). If the executive’s employment had instead been considered to terminate on the date provided under Swiss law (Swiss law prohibits termination of an employee while that employee is unable to work), the employee would have vested in additional options.

In contrast to the Ninth Circuit’s decision in Oracle, a state appeals court held that an executive’s employment terminated for vesting purposes under a restricted stock program not when the executive’s active employment ceased, but only after satisfaction of a 90-day written notice requirement for terminating employment. Booth (sic) v. Fred’s Inc., 2003 WL 21998410, 31 EBC 2260 (Tenn. Ct. App. 2003). The executive was terminated “for cause” for the negligent performance of his duties. His employment agreement required that the employer give 90 days advance written notice for a termination for cause (subject to certain exceptions not relevant). As a consequence, the executive vested in certain restricted stock shares because he was considered employed on a vesting date which occurred after his active employment ceased, but before the 90 days expired. The executive was also entitled to company-provided health insurance through the extended date. In contrast, for purposes of the company’s incentive stock option program, the employee was treated as terminated as of the earlier date when the company told him he was terminated because the ISO agreement expressly provided that termination of employment could be immediate where it was “for cause.”

[New Heading] Change in Control

In an unpublished decision, a state appeals court considered when a change in control was considered to occur. This was important because the plaintiff was employed on the date a
merger agreement was signed by the employer’s board of directors, but not on the later date when the company’s shareholders approved the transaction. The employee’s unvested restricted stock and stock options were to be cancelled on termination of employment, absent a change in control preceding that date. The court concluded that, for purposes of the restricted stock and stock option program at issue, a change in control occurred when the employer’s shareholders approved the transaction, not on the earlier date when the merger agreement was signed by the company’s board of directors. *Pasquel v. Airtouch Communications, Inc.*, 2002 WL 31813099 (Cal. Ct. App. 2002) (unpublished).

The Eighth Circuit concluded that there was no acceleration of stock options where a merger was blocked by government regulators. Instead, an acceleration of options would occur, under the terms of the plan, only if a merger were in fact to occur (and the company ceased to survive as an independent publicly-owned company), not when shareholders approve a merger. *Bohan v. Honeywell International, Inc.*, 366 F.3d 606, 32 EBC 2223 (8th Cir. 2004).

The Fifth Circuit held that a change in control provision under which an employee would vest if terminated “within 12 months” of a change in control applied only if the employee’s employment terminated following the change in control, rather than prior to the change in control. *Sanchez v. Verio Inc.*, 119 Fed. Appx. 616, 2004 WL 2980781, 34 EBC 2501 (5th Cir. 2004) (unpublished). The court found that the agreement unambiguously provided for a double trigger – that is, it required that there be both a change in control and that the employee be terminated without cause or voluntarily for good reason. The court overturned a jury verdict in favor of the employee, holding that the case should not have been submitted to the jury because the agreement unambiguously failed to provide for the acceleration of vesting. In determining that the agreement required the employee’s termination to occur following a change in control – despite the agreement’s provision providing for accelerated vesting if the termination occurred “within 12 months” of the change in control – the court looked to the entirety of the agreement and focused on other provisions indicating that (a) to the extent the employee was not entitled to exercise the options on her termination date, the options would terminate, and (b) the options would vest, if at all, only during the period of the plaintiff’s continuous status as an employee.

[New Heading] Sale of Subsidiary


[New Heading] Spinoff: Adjustment in Number of Options

In an unpublished decision, a state appellate court dismissed a derivative action alleging that officers and directors of a company breached their fiduciary duties in making adjustments to the company’s stock option programs following the spinoff of a subsidiary. The court also dismissed a related shareholder class action. *Shaev v. Claflin*, 2004 WL 1381037, 33 EBC 2367 (Cal. Ct. App. 2004) (unpublished), *reh’g denied* (July 20, 2004), *review denied* (Sep. 29, 2004). The stock option plans (one for employees and another for non-employee directors) had been adopted with shareholder approval and were administered by the company’s board. The plans
authorized the board to adjust the number and exercise price of outstanding options in the event of a stock dividend, stock split, reverse stock split, or “like change in the capital structure of the Company.”

A wholly-owned subsidiary of the company held an initial public offering, after which the company spun off the subsidiary by distributing the remaining subsidiary’s shares to the company’s stockholders. The stockholders received 1.4832 shares of subsidiary stock for each outstanding share of company stock they owned. The board, however, in adjusting stock options, awarded to optionholders 4.827 options for each option held just prior to the spinoff. This 4.827 figure was the ratio of the value of a share of the company’s stock just prior to the spinoff to its value immediately following the spinoff.

The court concluded that the option program authorized an adjustment in the number of outstanding options, either because the spinoff constituted a stock dividend or because it constituted a “like change in the capital structure” of the company. The court reached this conclusion in spite of the plaintiffs’ argument that under Delaware general corporation law a stock dividend can involve only a distribution of a company’s own shares, and not the shares of a subsidiary.

As to the propriety of the amount of the adjustment, the court concluded that the board was acting in accordance with the option plans approved by shareholders and, therefore, its actions were protected by the business judgment rule even if some benefit flowed to the directors by reason of their participating in the option program. The plaintiffs failed to allege facts supporting a claim of bad faith, fraud or gross negligence amounting to corporate waste. Absent those circumstances, the directors’ were entitled to the benefit of the business judgment rule and the shareholders were required to make demand on the board before filing suit.

[New Heading] Exercise by Estate

A state appeals court considered the right, if any, of the administrator of an estate to exercise stock options in Sams v. Video Display Corp., 255 Ga. App. 478, 566 S.E.2d 28 (Ga. Ct. App. 2002), reconsideration denied (2002), cert. denied (2002). The court concluded that the time for exercising stock options following an executive’s death was not tolled until the administrator of the estate was appointed. It also concluded that the estate’s administrator did not have standing to bring a negligent misrepresentation claim concerning the deadline for exercising options, where any misrepresentations were made to the beneficiaries of the estate, not to the administrator. The court did not foreclose the possibility of the beneficiaries of the estate bringing such claims.

[New Heading] Mutual Departure Doctrine

A federal trial court considered the consequences of an employer’s failing to follow the provisions of a stock option agreement, and whether those departures from the agreement’s terms would bind the employer going forward, in Snyder v. Time Warner, Inc., 179 F.Supp.2d 1374, 27 EBC 1745 (N.D. Ga. 2001). The court concluded that there was a question of material fact concerning whether, under Georgia law, the employer’s actions created a “mutual departure” from the terms of the stock option agreement. The former executive bringing suit sought to
exercise options later than the deadline set forth under the terms of the executive’s written stock option agreement. The options were set to expire on October 1, 1997, under the terms of the option agreement. The company had, however, sent the participant repeated status reports before and after this expiration date stating that the participant could exercise his options in years 2003 to 2006. The company even processed a request by the executive to exercise certain options in October 1998 (after they should have expired under the terms of the agreement). The court held that a jury could, under Georgia’s mutual departure statute, conclude the company granted stock options to the participant on terms other than those set forth in the agreement.

Meaning of “Vested”

The Second Circuit considered when amounts would be considered vested for purposes of interpreting a release in Becher v. Tyco Int’l Ltd., 27 Fed. Appx. 48, 2001 WL 1486209 (2nd Cir. 2001) (unpublished). The court concluded that certain executives’ releases prevented those executives from making claims for the accelerated vesting of options. The executives’ releases covered claims under employee benefit plans other than claims for “vested” amounts. The court was required to determine whether the options became “vested” at the trigger date for a special, time-limited opportunity to purchase optioned shares preceding a merger. In particular, the option program offered a 20-day window for purchasing option shares preceding a merger. The court concluded that this opportunity did not create a vested right, and therefore the executives’ releases’ exception for vested amounts was inapplicable. As a consequence, the executives could not, due to their releases, bring an action claiming a right to additional vested options. In concluding that the 20-day window for purchasing option shares preceding a merger did not create a vested right, the court characterized the 20-day window as a “time-limited opportunity” to purchase shares when the executives would not otherwise be entitled to do so under the plan’s normal schedule of vesting and exercise rights.

[New Heading] Prejudgment Interest

A federal trial court concluded that stock option agreements were ambiguous and their interpretation was, therefore, a proper issue for a jury. The court also held that a former employee, who had prevailed in his jury trial, was entitled to prejudgment interest on the liquidated value of his vested options where the employer had delayed payment because of the former employee’s refusal to release the claims at issue in the litigation. Edwards v. Schrader-Bridgeport Int’l, Inc., 205 F.Supp.2d 3, 28 EBC 1946 (N.D. N.Y. 2002).

[New Heading] Approval Process for Stock Options

The Second Circuit concluded that a proxy statement seeking approval of options for nonemployee directors need not disclose the grant-date value of those options. Resnik v. Swartz, 303 F.3d 147 (2nd Cir. 2002). The court distinguished the disclosure obligation for options provided to executive officers, in which case either the grant-date present value of those options or the potential realizable value of those options must be disclosed. See Subsections (c) and (g) of Item 402 of Regulation S-K.

[New Heading] Measure of Damages for Breach of Option Agreement
Wrongful Termination Preventing Stock Option Vesting

In apparent contradiction to the Ninth Circuit’s interpretation of Massachusetts law in *Fleming v. Parametric Tech. Corp.*, discussed in the Main Volume, the U.S. District Court for the District of Massachusetts concluded that there was no breach of the Massachusetts covenant of good faith and fair dealing in terminating an executive’s employment to prevent the executive from vesting in his stock options. *Cochran v. Quest Software*, 2002 WL 1998248, 29 EBC 1533 (D. Mass. 2002), aff’d 328 F.3d 1 (1st Cir. 2003). The court found support for its conclusion in a Massachusetts Supreme Judicial Court decision decided in 2001, after the Ninth Circuit’s earlier decision in *Fleming*. *Harrison v. NetCentric Corp.*, 433 Mass. 465, 744 N.E.2d 622 (Mass. 2001). The court also concluded that continued employment could constitute consideration for a change in the provisions of an option agreement. In particular, although the court said the employer could not unilaterally eliminate previously granted options under the plan, there had been an agreed upon reduction where the employee had signed an acknowledgment of that reduction. The participant’s continued employment was consideration for this change in the employee’s unvested options.

[New Heading] Disability Determination: Good Faith Requirement

A federal trial court concluded that an employer must act in good faith when determining whether an executive was disabled for the purpose of vesting under the employer’s stock option programs. The court reached this conclusion under both Connecticut and Texas law (Connecticut law applied to one stock option program and Texas to the other). Notably, the court reached its conclusion as to Texas law even though Texas, unlike many states, does not impose a general duty of good faith as to employment contracts. *Sadowski v. Dell Computer Corp.*, 268 F.Supp.2d 129, 31 EBC 1192 (D. Conn. 2003).

[New Heading] Proxy Statement Disclosure

The Ninth Circuit concluded that SEC proxy disclosure regulations do not require the use of the Black-Scholes option pricing model to report, in a proxy statement, the value of proposed stock option compensation for outside directors. *Seinfeld v. Bartz*, 322 F.3d 693 (9th Cir. 2003), cert. denied 124 S. Ct. 132, 157 L.Ed.2d 251 (2003). The case involved a derivative action brought by a shareholder against a corporation and its board of directors, alleging that a proxy statement violated (a) Section 14(a) of the Securities Exchange Act of 1934, which makes it unlawful to solicit a proxy “in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of
investors,” and (b) Rule 14a-9, which prohibits the solicitation of a proxy by means of a proxy statement that contains a statement that is “false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading.”

The plaintiff-shareholder complained about a representation in the proxy statement that unless the value of the company’s stock were to appreciate over the option term, no value would be realized from the option grants. The shareholder argued that this was materially false and misleading because “the grant of stock options results in the immediate realization of value,” which the plaintiff argued was best determined under the Black-Scholes model. The court concluded that the statement was not materially false, and with respect to disclosures required under Rule 14(a), looked to Item 8 of Schedule 14A, 17 CFR § 240.14a-101. Item 8 requires that a proxy statement furnish the information required by Item 402 of Regulation S-K, 17 CFR § 229.402. The court determined that although subsection (c) of Item 402 does require the disclosure of the value of options granted to certain executive officers, and specifically states that Black-Scholes is one possible way of calculating that value on the grant-date, there is no similar requirement in subsection (g) of Item 402 for outside directors.

[New Heading] Nonqualified Options: Taxation of Executive Subject to Lock-up Agreement

The Fifth Circuit affirmed a Tax Court decision addressing the timing of income inclusion where an executive is prohibited from selling stock for a period of time following exercise. Tanner v. C.I.R., 65 Fed. Appx. 508 (5th Cir. 2003) (unpublished). The taxpayers in Tanner – an executive and his wife – argued that they should not be taxed on the bargain element of stock options at the time of exercise because they were not “substantially vested” at that time. Under Section 83(a), a taxpayer is not taxed until his or her interest in property first becomes “substantially vested.” Treas. Reg. § 1.83-1(a)(1). For options to be substantially vested, a taxpayer’s interest must be transferable or not subject to a substantial risk of forfeiture. Treas. Reg. § 1.83-3(b). At issue in Tanner was the provision of IRC § 83(c)(3), under which a taxpayer’s rights in property are per se not transferable and are subject to a substantial risk of forfeiture (that is, not substantially vested) if the sale of the property at a profit by the taxpayer would subject the taxpayer to suit under Section 16(b) of the Securities Exchange Act of 1934.

The taxpayers argued that they were not substantially vested upon exercise of their options because, at the time of exercise, if they had sold the stock they would have been subject to liability under Section 16(b) for six months following the sale. The Tax Court, referring to Treasury Regulation § 1.83-3(j)(1), rejected this argument. The cited regulation provides that the protection from income inclusion applies only for a maximum of six months following purchase of the security. The court concluded that the 6-month period of protection began on the date the option was granted (when there was a purchase for Section 16(b) purposes) and not from the date of exercise (which was a non-event for Section 16(b) purposes).

The taxpayers also argued that the executive was not substantially vested, and therefore did not have taxable income at the time of exercise, because a lock-up agreement with the company prohibited the executive from selling his stock for a period of two years. The court said although the lock-up agreement did prevent the taxpayer from selling his stock, it did not prevent him from assigning that stock to another (and, in fact, the executive gave some of his
stock to relatives) or pledging it as collateral for a loan. Under Treasury Regulation § 1.83-3(d) this caused the shares to be transferable and therefore substantially vested. (The regulation provides that property is transferable and not subject to a substantial risk of forfeiture if it can be sold, assigned, or pledged.)

See also Revenue Ruling 2005-48, where restrictions on the sale of stock under Rule 10b-5 under the Securities Exchange Act of 1934, a company’s insider trading policy, and the terms of a “lock-up agreement” in connection with an initial public offering, did not constitute a substantial risk of forfeiture and cause the property to be non-transferable. In addition, these limitations did not constitute lapse restrictions and therefore would not be taken into account in valuing the stock. 2005-2 C.B. 259. Note also U.S. v. Tuff, 469 F.3d 1249, 39 EBC 1950 (9th Cir. 2006) (blackout periods applicable to insiders under employer’s insider trading policies did not constitute substantial risk of forfeiture); Hernandez v. U.S., 450 F.Supp.2d 1112 (C.D. Cal. 2006) (lock-up agreement did not result in substantial risk of forfeiture; case involved incentive stock options, which are normally not subject to tax under §83, but §83 substantial risk of forfeiture determination was important in determining application of alternative minimum tax); Merlo v. Commissioner, T.C. Memo 2005-178, 2005 WL 1692469, 35 EBC 2879 (2005) (insider trading policy does not create substantial risk of forfeiture where violation of policy does not result in forfeiture of shares, but instead results in workplace disciplinary proceedings; case involved application of alternative minimum tax to incentive stock options, which are not otherwise typically subject to §83 rules); TAMs 200338010-011 (lock-up agreement and insider trading restrictions did not delay AMT on exercise of ISOs, and were not nonlapse restrictions serving to reduce value of stock in determining tax).

[New Heading] Nonqualified Options: Taxation Where Shares Purchased with Third Party Margin Loans

Treasury Regulations interpreting Tax Code Section 83 provide that if the amount paid for property is in whole or in substantial part indebtedness secured only by the acquired property (i.e., nonrecourse debt), the transaction may be viewed as the equivalent of the grant of an option. Treas. Reg. § 1.83-3(a)(2). As a result, the acquisition of property with nonrecourse debt may not constitute a transfer of the property for purposes of Section 83.

In a case of apparent first impression, a federal trial court concluded that an employee was taxed upon exercise of nonqualified stock options, despite the employee’s argument that as a result of a broker-assisted cashless exercise program the employee essentially, after exercise, owned property that was tantamount to an option grant that should not be taxed by reason of Treasury Regulation Section 1.83-3(a)(7), example 2. Miller v. U.S., 345 F.Supp.2d 1046, 34 EBC 2517 (N.D. Cal. 2004), aff’d, 209 Fed. Appx. 690 (9th Cir. 2006) (unpublished). Through the company’s broker-assisted cashless exercise program, shares received by the employee upon exercise were held in a margin account and were pledged as collateral for a loan necessary to pay the exercise price (and pay withholdings taxes). The employee argued that it was very unlikely he would be required to pay any deficiency on the loan following foreclosure on the pledged shares, but conceded that he was in fact legally liable for any such deficiency. The court rejected the argument that this essentially made the property received by the employee itself an option grant, avoiding taxation under the cited regulation.
Since Miller, several other courts have addressed the issue, all reaching similar conclusions. In Hilen v. Comr., T.C. Memo 2005-226, 2005 WL 2387488 (2005), the Tax Court held that a taxpayer who borrowed funds from a bank to exercise nonstatutory stock options received gross income in the year he exercised the options, finding that the type of property transferred was the stock that the employee actually received and which included dividend and voting rights. The court distinguished Treas. Regs. §1.83-3(a)(7) from the taxpayer's case, pointing out that in the regulation’s example, the indebtedness was to the employer, not an unrelated third party, and was not a personal liability, but in Hilen, the taxpayer was personally liable to the bank that loaned him the money to exercise the options. The Ninth Circuit reached a very similar set of conclusions in U.S. v. Tuff, 469 F.3d 1249 (9th Cir. 2006). See also Palahnuk v. U.S., 70 Fed. Cl. 87, 37 EBC 1697 (2006), aff’d, 475 F.3d 1380 (Fed. Cir. 2007) holding, as did the Ninth Circuit in Tuff, that the taxpayer's purchase of stock using third-party margin debt did not qualify for the exception to transfer of property provided by Regs. §1.83-3(a)(2). The court reasoned that Regs. §1.83-3(a)(7), Ex. (2), is concerned with whether the employer has granted an employee an option to purchase property, and thus, the focus should be on what the employer transferred and received in exchange, not on what the employee paid or has at risk. Finding that the factors in Regs. §1.83-3(a)(2) weighed against treating the taxpayer's exercise of his options as the grant of an option, the court in Palahnuk concluded that the purchase of stock using third-party margin debt is not in substance the same as the grant of an option, citing Tuff v. U.S., 359 F. Supp. 2d 1129 (W.D. Wash. 2005), aff’d, 469 F.3d 1249, 39 EBC 1950 (9th Cir. 2006); Miller v. U.S., 345 F. Supp. 2d 1046 (N.D. Cal. 2004), aff’d, 209 Fed. Appx. 690 (9th Cir. 2006) (unpublished); Facq v. U.S., 363 F.Supp.2d 1288 (W.D. Wash. 2005); and Hilen v. Comr. See also Facq v. Comr., T.C. Memo 2006-111.


A federal district court concluded that an employee who was eligible for retirement benefits had not terminated employment by reason of “retirement” for purposes of the employer’s stock option program. Jones v. Bank of America, N.A., 311 F.Supp.2d 828, 32 EBC 1244 (D. Ariz. 2003). The plaintiff-employee’s employment had been terminated pursuant to a reduction in force (“RIF”). Under a special “bridging” rule in connection with the RIF, employees were treated as if they had one additional year of service for the purpose of retirement benefit eligibility. This bridge allowed the employee-plaintiff to become eligible for retirement benefits under a “rule of 70.” The stock option plan, however, required that employees meet a “rule of 75” (that is, that they have attained age 50, with at least 15 years of vesting service, and have a combined age and years of vesting service equal to at least 75) to enjoy an extended period for exercising their options following termination of employment. The court held that the stock option plan document, prospectus, fact sheet, vesting sheet, and a settlement agreement signed by the employee in connection with his receipt of severance pay under the RIF, were clear concerning this definition of retirement. Even if the employee – as he alleged – had been told by his superiors that his options would remain exercisable as if he were terminated due to a “retirement,” the employee would not be entitled to an extended period for exercising his options since the terms of the plan documents were clear.

[New Heading] State Taxation of Nonresidents

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A nonresident of New York was required to pay New York state income on the exercise of incentive stock options granted while the taxpayer was employed in New York. *In re Stuckless*, 2004 WL 1588551 (N.Y. Div. Tax. App. 2004). The court upheld the application of a memorandum issued by the New York Technical Services Bureau of the Taxpayer Services Division. That memorandum provided guidance on New York’s tax treatment of stock options, restricted stock, and stock appreciation rights received by nonresidents who are, or were, employed in New York. Under the memorandum the amount of income subject to New York state tax is the product of (a) the taxpayer’s gain on exercise, and (b) a fraction, the numerator of which is the total number of days worked by the employee inside New York state from the date of grant to the date of exercise, and the denominator of which is the total number of days worked by the employee both inside and outside the state during the same timeframe. Where, however, an employee exercises his or her options after termination of employment, the ratio is based on the period from the date of grant to the date employment ceases.

California’s State Board of Equalization ruled that income from a disqualifying disposition of incentive stock options was properly sourced to California, and was therefore subject to California state income tax. *In re Randall* (Cal. Bd. Eq. No. 260104 3/22/05). The taxpayer was a resident of Nevada. The portion of the income sourced to California was determined by the ratio of work days when services were performed in California to the ratio of all work days, for the period that served as the basis for the grant. Although the taxpayer was, at the time of the disqualifying disposition, a resident of Nevada, during the time the options were earned the taxpayer apparently spent most of his work days in California. The state taxed not only the bargain element at the time of option exercise, but also the increase in value of the stock between the date of exercise and the date of the disqualifying sale. In this regard, the Board refused to follow the New York rule in *Michaelson v. New York State Tax Commission*, 67 N.Y.2d 579, 496 N.E.2d 674 (N.Y. 1986), where the New York court ruled that a nonresident was not subject to New York state income tax on gain realized from any increase in the market value of stock from the time the option was exercised to the time the stock was sold. New York characterized this income as investment income rather than compensation income, and a nonresident taxpayer therefore could not be taxed on the amount.

[New Heading] State Wage Payment Statutes


Stock options were not wages under the Maryland Wage Payment and Collection Law because the employer had not promised the stock options prior to their actual grant. That is, the employer was under no obligation to grant the options prior to its actually doing so. *Vargheese v. Honeywell International, Inc.*, 424 F.3d 411, 36 EBC 1505 (4th Cir. 2005) (which was also *cited in Mazer v. Safeway, Inc.*, 398 F.Supp.2d 412 (D. Md. 2005)). The court distinguished the Pennsylvania and Colorado wage payment laws. 424 F.3d 418 n. 10, *citing Scully v. U.S. WATS, Inc.*, 238 F.3d 487, 26 EBC 1231 (3d Cir. 2001) and *Regier v. Rhone-Poulenc Rorer, Inc.*, 1995 WL 395948, at *6-7 (E.D. Pa. 1995), *aff’d*, 92 F.3d 1172 (3d Cir. 1996) (Pennsylvania law), as well as *Montemayor v. Jacor Communications, Inc.*, 64 P.3d 916 (Colo. Ct. App. 2002)
(Colorado law). The court found that the Maryland statute differed from the Pennsylvania and Colorado statutes in its use of the term “promise” when defining wages. One significance of the plaintiff’s inability to make his claim under the Maryland Wage Payment and Collection Law was that he was unable to avail himself of the enhanced damages available under that statute.

The Ninth Circuit certified two questions to the Idaho Supreme Court in connection with a dispute over an executive’s claims concerning stock options. The first was whether stock options could be wages under the Idaho wage payment law. If they could, the Idaho Supreme Court was also asked to indicate whether it is a factual issue whether stock options were issued as wages (that is, an issue to be resolved by a fact finder). Paolini v. Albertson’s Inc., 418 F.3d 1023, 35 EBC 2481 (9th Cir. 2005). The court noted that stock options are not wages under California’s wage laws, citing Falkowski v. Imation Corp., 309 F.3d 1123, 1132, 29 EBC 2267 (9th Cir. 2002), on remand to, 132 Cal. App. 4th 499 (Cal. App. 2005) (discussed supra under the heading Stock Sale: Time Limit for Exercise) and International Business Machines Corp. v. Bajorek, 191 F.3d 1033, 1039 (9th Cir. 1999), but that the Third Circuit has concluded that a stock option does constitute wages under the Pennsylvania Wage Payment and Collection Law “if the employer specifically agreed to deliver the option as employment compensation,” citing Sculley v. U.S. WATS, 238 F.3d 497, 517-18, 26 EBC 1231 (3d Cir. 2001).

The Supreme Court of Idaho accepted the certified questions from the Ninth Circuit. The Idaho court concluded that stock options (and other nonmonetary compensation) are not wages under the Idaho wage payment law. Paolini v. Albertson’s Inc., 143 Idaho 547, 149 P.3d 822 (Idaho 2006).

Following the decision by the Idaho Supreme Court on the certified questions, the Ninth Circuit returned to the substantive claims in Paolini. Paolini v. Albertson’s Inc., 482 F.3d 1149, 40 EBC 1676 (9th Cir. 2007). The court first concluded that under the terms of Albertson’s stock option plan, a change in 20 percent or more of the incumbent directors is not enough, by itself, to constitute a change in control resulting in accelerated vesting. Instead, the change in incumbent directors must be in connection with a merger, consolidation, or reorganization. In the instant case, the change in directors was simply the result of a reduction in the size of the board, which occurred at the same time the company announced a significant restructuring plan that included store closings, division consolidations, and process streamlining.

The court, after hearing from the Idaho Supreme Court on the certified questions, rejected the plaintiff’s argument that he was wrongfully discharged in retaliation for asserting that he was entitled to accelerated vesting and for acting to exercise his options. The plaintiff argued that his termination had constituted a violation of Idaho’s wage laws, public policy, and a covenant of good faith and fair dealing. The Idaho Supreme Court, in answering the question certified to it by the Ninth Circuit, said stock options are not wages under Idaho wage payment law. Apparently the only argument made by the plaintiff for a public policy exception to his at-will employment relationship was based on the options constituting wages under the state wage payment law. Since those options were not wages for that purpose, the discharge of the plaintiff did not constitute a violation of public policy. The court said that it violates the implied covenant of good faith and fair dealing when a party to a contract takes action to impair rights or benefits due under the contract. In the instant case, the plaintiff was not entitled to exercise the options when he was discharged, so he could not have been denied rights to benefits due him,
and therefore there could be no violation of an implied covenant of good faith and fair dealing. The court also rejected the plaintiff’s argument that the employer’s loans to the plaintiff to cover margin calls on the employer’s stock need only be repaid if the plaintiff were to continue to be employed. Finally, the court also rejected the plaintiff’s argument that the promissory notes limited the employer’s ability to fire the plaintiff as an at-will employee.

[New Heading] Retaliatory Discharge: Attempt to Exercise Options

The court in *Paolini*, *supra*, also certified to the Idaho Supreme Court a related question. The plaintiff had argued that he was fired because he attempted to exercise his stock options. The employee argued that this was a retaliatory discharge in violation of Idaho’s wage laws, public policy, and the covenant of good faith and fair dealing. The Ninth Circuit certified to the Idaho Supreme Court the question whether firing an employee for trying to exercise his right to receive wages is a violation of public policy, noting that Idaho has long recognized a public policy exception to the ability to terminate at-will employees.

[New Heading] Failure to Tender Payment with Exercise Notice

In *Deal v. Consumer Programs, Inc.*, 470 F.3d 1225, 39 EBC 1945 (8th Cir. 2006), a former executive who was terminated without cause following a change in control was entitled to an annual bonus as well as base salary for the full year of termination where her employment agreement entitled her to a lump sum cash severance payment (equal to 200 percent of base annual salary) and all remedies available under law for damages suffered by reason of her involuntary termination. The court indicated that under Missouri law, the former executive was entitled to damages equal to the remaining amount she would have received if the employer had fully performed under the contract. Because the contract’s term renewed annually unless notice of renewal was given (and it was not), this meant the former executive was entitled to payment of the full compensation she would have received through the end of the current one year term.

The former executive was unsuccessful, however, in recovering the value of stock options she claimed because although she gave timely notice of her wish to exercise, she failed to tender the purchase price with that notice, as required under the terms of a separate written option agreement. Apparently because the company failed to pay her amounts she believed (and, as it turns out, she was correct in believing) she was owed under the employment agreement, the former executive assumed the company might also fail to perform under its obligations under the stock option agreement. She therefore sent a letter, through her counsel, giving written notice of her intent to exercise and demanding the other payments she believed she was due under her employment agreement. She did not, however, accompany her letter with full payment of the shares’ purchase price. Rather, the letter stated that she “intends to exercise her options pursuant to the parties’ Stock Option Agreement . . . and is prepared to tender cash in the amount of $210,004 for her stock.” She went on to say “please inform me if [the company] intends to perform its agreement under that contract.” The company failed to respond to the letter and the former executive’s counsel sent a second letter saying that the former executive would not pay the purchase price for the stock. The letter said she assumed if she sent payment the company would keep the money and refuse to issue the stock due her.
The court rejected the former executive’s argument that she had a right to treat the purchase price for the stock as a setoff against other amounts owed her by the company. The court indicated that Missouri law does not favor options to purchase property and options are, therefore, strictly construed against the optionee. Because there was no indication of any right to set off in the stock option agreement, the court was unwilling to imply one. The court also rejected the former executive’s argument that her payment was excused because the company had breached its duty of good faith and fair dealing under the option agreement. The court said the option was a unilateral contract, separate from the former executive’s employment agreement, which would not come into existence until it was accepted in the prescribed manner (under the terms of the option agreement). Because the former executive failed to accept in the prescribed manner (by tendering payment with her exercise notice), there was no enforceable contract. The court also held that the company was not estopped from enforcing the requirement that payment be tendered upon providing notice of exercise, despite the former executive’s argument that another employee had not been required to submit payment with his exercise notice. The court found this past practice to be of no consequence because the former executive had not been a party to the agreement with the other individual and could not rely on the employer’s conduct under a separate agreement, even if it occurred, as precedent under the former executive’s own agreement. The court concluded that nothing in the record indicated an unequivocal and intentional relinquishment by the employer of the requirement of the agreement to tender payment with notice of exercise.

[Vesting: Acceleration Upon Termination, Share Price Trigger]

The Sixth Circuit concluded that the decision of a stock option plan administrator to deny accelerated vesting upon termination of employment was not arbitrary and capricious in Ziegler v. HRB Management, Inc., 182 Fed. Appx. 405, 38 EBC 1135 (6th Cir. 2006) (unpublished). Under the plan, options vested upon the earlier of the fifth anniversary of the date of grant, or the day after the 30th consecutive trading day with the stock having a closing market price of at least $60. The plan provided for accelerating vesting upon termination of employment if the options were granted at least six months prior to termination of employment and the options “would have vested during the 18-month period following [termination of employment] had the Participant remained an employee with the Participating Employer . . .” At the time of his termination, the employee was not within 18 months of the fifth anniversary of the grant. The market price for the stock did, however, satisfy the $60 trigger within the 18 months following termination. The court held that the stock option plan provision accelerated vesting only where the participant would vest within 18 months of termination as a result of time vesting (that is, under the fifth anniversary rule). The court reasoned that if the rule were otherwise, so accelerated vesting could occur where the market price trigger is satisfied within the following 18 months, the employer could not know at the time employment terminates whether to “immediately” vest the employee in his or her options. The court thought it notable that in the quoted language above the plan used the word “would,” which the court thought implied that vesting must be a certainty and must not depend on the satisfaction of any contingency.

Termination and Severance

[Employer’s Ability to Eliminate Benefits]
In a split decision, the Fifth Circuit permitted an employer to amend a change in control plan to eliminate an executive as a participant. *Habets v. Waste Management, Inc.*, 363 F.3d 378, 32 EBC 2465 (5th Cir. 2004). The court’s reading of the relevant plan language was, to this author, surprising.

The defendant-employer had created a “key executive severance plan.” Under that program, if a participant were terminated from employment (including pursuant to a voluntary resignation) within three years of a change in control of company management, the participant was entitled to receive a severance compensation package which the court described as “generous.” The executive who brought suit previously had been named as a plan participant by the board of directors’ executive compensation committee, and his name had been added to a company document entitled “Exhibit 1,” which listed all plan participants. The executive, in connection with a corporate restructuring, underwent a change in job responsibilities (though not job title), and the executive compensation committee of the board thereafter approved a new list of eligible participants which did not include the executive.

The executive argued that once he was made a participant the company had, under the plain terms of the plan, no unilateral ability to remove him as such. The relevant plan terms provided as follows:

1.1.4. *Participant*: The term “Participant” shall mean the officers of the Company or its subsidiaries who are listed on Exhibit 1 hereto and such additional officers of the Company or its subsidiaries as the Board of Directors of the Company may, by resolution duly adopted prior to any Change in Control, from time to time specify as being a Participant in this Plan.

2.2 *Amendments, Etc.*: Prior to the expiration of the Plan Period, the Company shall not amend, terminate or suspend the Plan or any provision hereof, including without limitation this Section 2.2, without the prior written consent of any Participant adversely affected thereby . . . .

2.3. *Certain Limitations*: Without limiting any rights which any Participant may have under any Other Plan, nothing in this Plans shall grant any Participant any right to remain an executive officer, director or employee of the Company and/or any of its subsidiaries, whether or not a Change in Control shall occur.

Reasonably, at least in the view of this author, the executive argued that Section 2.2 prohibited an amendment to Exhibit 1 deleting a participant from eligibility without the participant’s written consent. Consistent with this, the executive argued that the provision in Section 1.1.4 permitting the board of directors to name *additional* officers to become participants did not imply an ability to *remove* individuals as participants. A majority of the court, however, concluded that the clear meaning and intent of Section 1.1.4 was to permit the board to “specify” from time to time those persons entitled to severance benefits upon a change in control, despite that section’s use of the word “additional.” As to Section 2.2, concerning the company’s ability
to amend the plan, the court concluded that the provision was not a restriction on the company’s ability to amend Exhibit 1 (and thereby remove an individual as a participant), but instead required the individual consent of adversely affected participants only when the plan “generally” was to be amended or terminated, not when an individual participant was being removed by the board. The court seemed to take support for its conclusion from Section 2.3, despite the executive’s argument that Section 2.3 simply made clear that a participant had no right to remain as an executive officer or employee, and did not suggest that an executive had no right to remain a participant.

[New Heading] Employer’s Ability to Modify Severance Benefits

An employer was permitted to apply the modified terms of a severance plan to an executive, including modifications adopted after the executive was told his employment would be involuntarily terminated (but adopted before the date of the executive’s termination). *Chacko v. Sabre, Inc.*, 36 EBC 1634 (N.D. Tex. 2005), *aff’d*, 473 F.3d 604, 39 EBC 2372 (5th Cir. 2006). The new severance plan required, as a condition to the payment of benefits, that a terminated employee sign a general release, which included noncompete and nonsolicitation provisions. The version of the plan previously in effect had required a release, but apparently had not included noncompete and nonsolicitation requirements. The modified program also permitted the employer to choose whether payments would be made in a lump sum or instead over a period of eight months. The prior document had provided simply for payment in a lump sum. The court noted that the plan document permitted the employer to modify the program, and that employers may modify or eliminate previously offered welfare benefits that are neither vested nor accrued. In the circumstances at hand, the court concluded that the executive had no vested right to severance benefits until the date his employment terminated.

[New Heading] Employer’s Ability to Modify Retiree Welfare Benefits

A federal district court allowed a company to modify the retiree welfare benefits provided to a former executive in *Markowitz v. Celanese Corp.*, 2006 WL 2689836, 39 EBC 1158 (D. N.J. 2006). The former executive had agreed to retire early, and at that time began receiving generous retiree medical and dental coverage. The former executive alleged that the President of the company, when approaching him to discuss the possibility of his early retirement, had promised, in conversation and in writing, that the executive would receive full medical and dental benefits for life. In fact, however, those benefits were reduced a few years later, following an acquisition. The court held that the former executive had no valid ERISA claim for lifetime retiree welfare benefits because there was no clear or express lifetime promise of benefits in the plan documents, the most important of which was the summary plan description. The court refused to consider a chart attached to a letter agreement concerning the executive’s retirement, which included an entry that read:

Medical 100% for life (free)
Medicare Suppl.

The court refused to consider this notation in the letter agreement as being part of the relevant and binding plan document “given the short-hand nature of the document and its description of [the former executive’s] benefits only.” The court was similarly unswayed by an internal
company document which included a chart with an entry that stated, with respect to the executive:

<table>
<thead>
<tr>
<th>Plan</th>
<th>Coverage/Life</th>
<th>Paid by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Plan</td>
<td>100%</td>
<td>[the employer]</td>
</tr>
<tr>
<td>Dental Plan</td>
<td>100%</td>
<td>[the employer]</td>
</tr>
</tbody>
</table>

The former executive’s promissory estoppel claim did, however, survive the defendant’s motion for summary judgment, since the parties disagreed on the relevant facts.

[New Heading] *Termination for “Good Reason:” Employer’s Opportunity to Cure*

The Second Circuit upheld a district court decision denying severance benefits under an employment agreement, because the covered executive failed to provide the employer with a reasonable opportunity to cure its breach of the employment agreement. *Needham v. Candie’s, Inc.*, 30 EBC 2657, 2003 WL 1973372 (2d Cir. 2003) (unpublished), aff’d 29 EBC 1529, 2002 WL 1896892 (S.D. N.Y. 2002). The executive had entered into an employment agreement for an initial one-year term, with automatic extensions for three-month intervals unless written notice to the contrary was provided on three-month anniversaries of the original effective date. This arrangement effectively provided for a minimum three-month severance period. Under the agreement, the executive was entitled to a yearly base salary of $170,000, benefits under a stock option plan, and various other benefits. The executive could terminate his employment at any time for “good reason,” provided he gave the employer prior written notice of the basis for his proposed termination and a reasonable chance to cure. Upon a termination for good reason, the executive was entitled to six-month’s compensation and would vest immediately in all of his awards under the employer’s stock option plan. The term “good reason” included a “proposed material modification” of the executive’s work duties or position.

Approximately nine months into the contract, the executive’s superiors, who were critical of the executive’s job performance, offered the executive a lesser position at lesser pay. The executive asserted that he was told acceptance of the new position was the only way he could remain with the company. Several days later the executive met with the company’s president, who the executive claimed reiterated the terms of the proposed new position and indicated that the reduction in salary was not negotiable.

After considering the company’s offer of a reduced position, the executive wrote to the company’s president stating that he was declining the new position and terminating his employment for “good reason.” The executive felt that the new position constituted a proposed material modification of his duties, which would constitute good cause for termination. The executive claimed entitlement to six month’s continuation of salary and benefits, as well as the vesting of all unvested stock options. He did not, however, demand that the company rescind the proposal to change the executive’s position or otherwise refer to the “cure” provision of the employment contract.

The court concluded that offering the company an opportunity to cure was a condition precedent to the company’s obligation to pay the executive six month’s continuation of salary
and benefits. The executive argued it was unnecessary to offer the company such an opportunity because the company had indicated its position was not negotiable, and therefore offering an opportunity to cure would have been futile. The court disagreed, stating that the company continued to pay the executive’s then current salary and benefits following its offer of the new position, and the alleged statements concerning the nonnegotiability and conditioning of continued employment on a change of status did not indicate an unequivocal intent on the employer’s part to forego performance of its obligations under the employment agreement. The court found that the executive had not offered evidence that the employer had repudiated or rejected the available mechanisms for continuation or termination of the employment agreement. The court seemed to find it noteworthy that the employer had a right, at three-month intervals, to prevent the automatic renewal of the contract, which would have effectively triggered only three month’s of severance compensation.

[New Heading] Termination of Employment: Date of Termination, Cure

In an unreported decision, the Fourth Circuit concluded that for the purpose of computing severance benefits an executive terminated employment on the date he submitted a letter of resignation, not on the expiration of a 30-day “cure” period during which the employer was entitled to reverse changes in executive’s employment following a change in control that would otherwise make the resignation a constructive termination. Although the employer had a 30-day period in which to cure events giving rise to a “constructive termination event” – which, if cured, would permit the employer to avoid the obligation to pay severance benefits – this 30-day period determined only whether the termination was a constructive termination, not the actual event of termination should the employer fail to cure. This was important in determining the amount to be paid as severance under the agreement at issue. *McCormack v. Computer Sciences Corporation*, 99 Fed. Appx. 458, 33 EBC 1321 (4th Cir. 2004) (unpublished).

[New Heading] Date of Termination

The Ninth Circuit held that a compensation committee could properly conclude that a Swiss employee ceased to be employed for purposes of a stock option plan on the date the employer said the executive was terminated (a date as of which the executive no longer provided services), even though under Swiss law (which governed the executive’s employment contract) the executive was still employed, where the stock option plan included a California choice of law provision and granted discretion to the compensation committee to decide when an individual ceased to be employed. *Oracle Corp. v. Falotti*, 319 F.3d 1106, 29 EBC 2687 (9th Cir. 2003), *cert. denied*, 540 U.S. 875, 31 EBC 2760 (2003). If the executive’s employment had instead been considered to terminate on the date provided under Swiss law (Swiss law prohibits termination of an employee while that employee is unable to work), the employee would have vested in additional options.

[New Heading] “For Cause” Termination

The Ninth Circuit rejected an employer’s argument that an employee had been terminated for “cause” where the former executive was terminated to facilitate the sale of a division in which he worked, not because of any shortcomings in his performance. *Scribner v. WorldCom, Inc.*, 249 F.3d 902, 26 EBC 1860 (9th Cir. 2001). The court said the term “cause,” as used in
option contracts, meant a termination due to some fault or shortcoming on the part of the employee. The court also rejected the employer’s argument concerning the degree of deference to be paid to the plan committee’s decision. The court said the committee’s discretion to define terms in the contracts was the discretion to determine whether an employee had in fact been terminated for deficient performance, not the discretion to redefine the term “cause.” Finally, the court concluded that the committee breached its duty of good faith and fair dealing, which it owed under Washington law, when it found the employee’s termination to be with cause for the purpose of the option contracts.

The Seventh Circuit rejected summary judgment for a company on a claim by a former executive that she was not terminated “for cause.” *Joy v. Hay Group, Inc.*, 2005 WL 797192 (7th Cir. 2005). The executive’s employment contract excused the employer from paying severance (equal to one year’s pay) if the executive’s termination was “for cause.” The Seventh Circuit concluded that, under Illinois law, this “for cause” provision was ambiguous and, therefore, summary judgment for the employer was not warranted where the employee claimed she was terminated for not reaching her quota for annual billings.

In contrast, the Fourth Circuit found that a severance provision of an employment agreement, which provided for paying one-year’s base salary if the executive were terminated without cause, was not ambiguous. *Gresham v. Lumbermen’s Mutual Casualty Company*, 173 Fed. Appx. 220, 2005 WL 844728 (4th Cir. 2005) (unpublished). The provision was unambiguous because state (Maryland) common law defined “cause” for termination of employment as a material breach of the terms of the employee’s employment agreement. The court concluded that the executive’s termination was not, in fact, for cause because the termination was a result of the employer’s sale of the portion of its business in which the executive was employed. The executive’s voluntary acceptance of a position with the purchaser did not change the conclusion that the company, by its sale of the business employing the executive, made it impossible for the executive to continue his employment. The court also found that state breach of contract and state wage payment claims for severance were not preempted because the severance provisions of the executive’s offer letter, which served as an employment agreement, did not provide for benefits under the employer’s ERISA-governed severance plan. In reaching this conclusion, the court found it notable that benefits under the more formal severance plan would have been smaller in amount and would not have been payable were the executive offered employment by an acquiring company (in contrast to the terms of the employment agreement).

A federal district court upheld, under an arbitrary and capricious standard of review, a nonqualified plan committee’s determination that an executive was terminated for cause. The committee had, as a result, authority under the plan’s terms to conclude that the executive’s benefits were forfeited. *Berg v. BCS Financial Corporation*, 2006 WL 273541, 37 EBC 2339 (N.D. Ill. 2006). The court upheld the committee’s finding that the executive was terminated for cause because, among other reasons, the executive had taken action to mislead the company into paying him increased benefits to which he was not entitled.

An employee was not entitled to severance benefits where her termination for viewing computer files in a folder maintained by her supervisor, in violation of company policy, was a termination for cause under the terms of the severance plan. *Johnson v. U.S. Bancorp Broad*
Based Change in Control Severance Pay Program, 424 F.3d 734, 35 EBC 2217 (8th Cir. 2005), reh’g en banc denied (2005). The claimed benefits were under a severance plan implemented to provide payments to employees terminated without cause within 24 months of a corporate merger. No benefits were, however, to be paid in the event of a termination “for cause,” which was defined as including “gross and willful misconduct during the course of employment.” The plan defined “gross and willful misconduct” as “includ[ing] . . . acts or omissions which violate the Employer’s Rules or Policies (such as breaches of confidentiality).” The court found that the committee administering the plan reasonably interpreted “cause” to include violations of company policies relating to unauthorized employee access to computer data. The court reviewed the plan committee’s denial of benefits under an abuse of discretion standard, so the court was restricted to determining whether a reasonable person could have interpreted and applied the plan in the fashion the committee did.

A federal district court later reached the same result as in Johnson in connection with another employee of the same company, who was also terminated for unauthorized access to computer records in files maintained by the very same supervisor as in Johnson. Anderson v. U.S. Bancorp, 2006 WL 2130440, 39 EBC 1299 (2006). The Eighth Circuit subsequently affirmed the district court decision in Anderson v. U.S. Bancorp, 2007 WL 1189426, 40 EBC 1865 (8th Cir. 2007).

Under an arbitrary and capricious standard, the First Circuit upheld an employer’s decision (as plan administrator) that the termination of an executive for forwarding e-mails to a competitor was a termination for cause. As a result, no benefits were payable under the employer’s severance plan. Madera v. Marsh USA, Inc., 426 F.3d 56, 37 EBC 1124 (1st Cir. 2005). The employer was an insurance brokerage and the executive forwarded to competitors seven e-mails, including the employer’s instructions to its employees on how to communicate with clients concerning the lowering of ratings of certain insurance companies, the employer’s business goals, and listings of promotions and reassignments of employees.

[New Heading] “Gross Misconduct:” After Acquired Evidence

A Tennessee appellate court considered a company’s denial of severance pay to an executive on the ground that the executive had engaged in “gross misconduct” by reason of actions discovered by the company only after the executive had been involuntarily terminated. Teter v. Republic Parking System, Inc., 2004 WL 2419082 (Tenn. Ct. App. 2004), rev’d, 181 S.W.3d 330, 37 EBC 1245 (Tenn. 2005). The executive was, under the terms of his employment agreement, entitled to severance pay in the event he was discharged for any reason other than gross misconduct, fraud, embezzlement, theft, or voluntary termination. The company had attempted to negotiate a modified arrangement with the executive involving changes in the executive’s responsibilities and compensation. The executive rejected the proposed changes and his employment was apparently terminated shortly thereafter. The company discovered, following the executive’s termination, that the executive had been using the company’s computer during regular business hours to access pornographic websites. The company argued that had it known the executive was accessing those websites it would have discharged him for engaging in gross misconduct, in violation of company policy. The company submitted, therefore, that the executive was not entitled to any severance pay due to his alleged gross misconduct.
The court stated that the issue of the use of “after-acquired evidence” in employment matters was a matter of first impression in Tennessee. The court held that:

When an employer wishes to use after-acquired evidence to prove grounds for dismissal, the employer must show, by clear and convincing evidence, that the wrongdoing was so severe that the employee would have been discharged on that ground alone if it had been known to the employer at the time of the termination.

The court concluded there was no clear and convincing evidence the company would have discharged the executive solely for viewing pornography on his computer. As a consequence, the company failed in its attempt to use after-acquired evidence to show that the executive engaged in gross misconduct.

The Supreme Court of Tennessee reversed the Court of Appeals. Teter v. Republic Parking System, Inc., 181 S.W.3d 330, 37 EBC 1245 (Tenn. 2005). The court agreed with the appellate court that an employer may use after-acquired evidence of employee misconduct in defense of a breach of contract case if the employer can demonstrate that it would have fired the employee had it known of the misconduct. Rather than applying a clear and convincing standard to the evidence, the Supreme Court of Tennessee, however, held that the evidence need only be shown by a preponderance of the evidence. The court therefore remanded the case for trial on the question whether the employee would have been terminated for gross misconduct had it known of the downloaded pornography.

[New Heading] Severance: Termination for Cause

The president of a nonprofit corporation was terminated for cause where he approved substantial compensation and benefits for himself and the CFO without properly informing the board. Miniace v. Pacific Maritime Association, 424 F.Supp.2d 1168, 37 EBC 2555 (N.D. Cal. 2006). The court upheld an independent fiduciary’s decision that the president was terminated for cause, and therefore not entitled to severance benefits, where the president approved compensation and benefits far in excess of what was provided for under his employment contract without seeking authorization from the board for these increases in his compensation, and in fact, without even disclosing the increases. The court applied an abuse of discretion standard in reviewing the plan administrator’s decision. In doing so, it quoted a sister district court’s summary of the ways in which a plan administrator can abuse its discretion. The court indicated that administrators abuse their discretion if they render decisions without any explanation, or construe provisions of the plan in a way that conflicts with the plan language of the plan. An administrator also abuses its discretion “if it relies clearly on erroneous findings of fact in making benefits determinations,” “fails to develop facts necessary to make its determination,” or “arbitrarily refuse[s] to credit a claimant’ reliable evidence.” In addition, an “error of law constitutes an abuse of discretion.” In contrast, “a decision grounded on any reasonable basis” is not an abuse of discretion. (Quoting Lundquist v. Continental Casualty Co., 394 F.Supp.2d 1230, 1245 (S.D. Cal. 2005).

Constructive Discharge
The First Circuit found that a jury had sufficient evidence to conclude that stock options should vest under a constructive discharge provision of an option agreement’s change in control rules. *Kerkhof v. MCI WorldCom, Inc.*, 282 F.3d 44, 27 EBC 2806 (1st Cir. 2002). The executive argued that his compensation had been reduced by the elimination of bonus and stock option compensation. The court held that a jury could conclude that the loss of those programs constituted a material reduction in compensation, and that the former employee as a consequence suffered a “constructive involuntary termination,” triggering immediate vesting even though the employee would have left the employer had there been no constructive discharge.

There was, in contrast, no constructive discharge for option vesting purposes where an executive began looking for a new job before his responsibilities were reduced, and where his responsibilities following the reduction were “critical to the survival of the company” and involved the performance on a full-time basis of duties commensurate the former executive’s experience and abilities. *Stensrud v. MetLife Investors Ins. Co.*, 2002 WL 1611591, 29 EBC 1190 (N.D. Ill. 2002).

**Covenants Not to Compete**

A federal trial court concluded that a top hat plan could provide for the forfeiture of future benefit payments upon a former employee engaging in a business activity substantially similar to, or competitive with, any business activity of the employer. *Bryan v. The Pep Boys – Manny, Moe and Jack*, 2001 WL 752645, 26 EBC 2276 (E.D. Pa. 2001).

A federal district court considered a noncompetition clause under which certain stock options and restricted stock would be cancelled should an executive compete with the employer in *Lucente v. International Business Machines Corp.*, 262 F.Supp.2d 109, 31 EBC 1198 (S.D. N.Y. 2003). The court concluded that documents concerning how the employer had interpreted and enforced noncompetition agreements with other employees were discoverable. In explaining the relevance of the requested documents, the court discussed New York’s “employee choice” doctrine, under which New York courts will enforce a restrictive covenant without regard to its reasonableness if the employee was afforded a choice between (a) not competing (and thereby preserving his or her benefits), or (b) competing (and thereby risking forfeiture of those benefits). Under the employee choice doctrine, a restrictive covenant under a benefit program is enforceable without regard to reasonableness if the former executive leaves his or her employer voluntarily. In contrast, if the former executive who brought suit was terminated involuntarily and without cause, the court is required to determine whether the employer’s covenant was “reasonable” in order to determine whether the covenant is enforceable.

The court indicated that even if a covenant were reasonable (or the former executive left voluntarily so reasonableness were not required), the covenant could not be enforced if the employer (or a plan committee designated to interpret the plan) acted fraudulently, arbitrarily, or in bad faith in determining that the former executive was employed by a competitor. The court concluded that the documents the former executive sought to discover, concerning how the employer had interpreted and enforced noncompetition agreements with other employees, was relevant in determining whether the employer had acted arbitrarily, in bad faith, or fraudulently in determining whether the former executive worked for a competitor and thereby forfeited stock options and restricted stock.
This district court decision in *Lucente, supra*, followed a reversal and remand of the district court’s prior decision at 117 F.Supp.2d 336, 25 EBC 2769 (S.D. 2000). The earlier decision was reversed by the Second Circuit at 310 F.3d 243, 29 EBC 2414 (2d Cir. 2002). The Second Circuit had concluded that the district court erred in determining, on a summary judgment motion, that New York’s employee choice doctrine was inapplicable. The Second Circuit explained that there are three well-established principles concerning the employee choice doctrine. First, an employer can rely on the doctrine only if it can demonstrate its continued willingness to employ the party who covenanted not to compete. Second, when an employee is involuntarily discharged without cause, the employer cannot invoke the doctrine. Third, the factual determination of whether an employee was involuntarily terminated is generally not appropriate for summary judgment. The Second Circuit held that the district court had ignored substantial evidence that the executive’s departure may have been voluntary and that IBM may have been willing to continue to employ the executive.

The Second Circuit also reversed the district court’s determination of damages with respect to the executive’s restricted stock and stock option benefits (which determination of damages will be of consequence only if the executive ultimately prevails). The district court had concluded that the executive treated a letter from IBM canceling his restricted stock and stock options following his acceptance of employment with a competitor as a breach of contract, but only with regard to the restricted stock – while treating the same letter as a mere anticipatory repudiation which the executive claimed he elected to ignore with regard to the stock options. This was an important division because where there is anticipatory repudiation – that is, where, before the time for performance has arisen, a party to a contract declares its intention not to fulfill a contractual duty – the nonrepudiating party has two (mutually exclusive) options. The nonrepudiating party may either (a) elect to treat the repudiation as an anticipatory breach and seek damages for breach of contract, thereby terminating the contractual relation between the parties, or (b) continue to treat the contract as valid and await the designated time for performance before bringing suit. The court indicated that the nonrepudiating party must, however, make an affirmative election among these options, though there is no specific time limit within which the election must be made. The Second Circuit reversed the district court and concluded as a matter of law that the executive had, by his conduct, elected to treat IBM’s cancellation letter as a breach of contract with respect to both his restricted stock and his stock options.

The district court, in determining a measure of damages for the executive’s restricted stock, had looked to the value of that stock as of a date eight months after IBM purportedly breached its contract. It did so because the executive would not have been entitled to receive the restricted stock until that time. In *dicta*, the Second Circuit questioned whether the district court was correct in measuring restricted stock damages as of a date after the date of the breach. It questioned this conclusion even though the restricted shares would have remained in escrow until the later date used by the district court.

The Second Circuit concluded that, under the New York Employee Choice Doctrine, it is permissible for an employer to condition post-employment benefits upon satisfaction of a restrictive covenant, whether or not that covenant is reasonable, if the termination of employment is voluntary and the employee makes an informed decision between forfeiting benefits and retaining benefits by avoiding competitive work. *Morris v. Schroeder Capital*
Management International, 481 F.3d 86 (2d Cir. 2007). The Second Circuit had certified to the New York Court of Appeals the question whether, in determining whether a departure was voluntary when an employer does not explicitly terminate an employee without cause, the court should look at whether a constructive discharge occurred. The New York Court of Appeals answered this question in the affirmative. That is, a constructive discharge would be considered an involuntary termination for purposes of the New York Employee Choice Doctrine, so that conditioning post-employment benefits upon satisfaction of a restrictive covenant would be permissible only if the covenant were reasonable. The instant employee’s lawsuit was, however, dismissed because the employee voluntarily terminated and did not adequately allege that the employer made the employee’s working conditions “so intolerable that the employee [was] forced into an involuntary resignation.” The court said the quoted language sets forth the federal law test for constructive discharge, which is to be applied in the context of terminations under New York’s Employee Choice Doctrine.

A federal district court interpreted Pennsylvania law in a fashion akin to that under New York’s employee choice doctrine, in Fraser v. Nationwide Mutual Insurance Co., 334 F.Supp.2d 755 (E.D. Pa. 2004). The court concluded that a provision in an insurance agent’s employment agreement providing for the forfeiture of deferred compensation if the agent competed with the insurer within a 25 mile radius within one year of termination of employment was enforceable under Pennsylvania, whether or not the 25 mile/one year limitation were enforceable by injunction as a prohibition on employment. The court noted that Pennsylvania’s policy against restrictive covenants was intended only to protect an employee’s interest in earning a living, and the forfeiture provision at issue did not prevent the employee from competing to earn a living. Instead, the employment agreement simply provided for the forfeiture of deferred compensation. Upon termination of his employment, the agent had two options: he could choose to compete and consequently forfeit his deferred compensation, or he could choose not to compete and receive his deferred compensation. Imposing this choice upon an employee did not violate Pennsylvania law, whether or not the restriction on competition was reasonable.

Notably, the deferred compensation program did not provide for voluntary deferrals. Instead, it provided additional compensation to employees who had been agents for at least five years and did not compete impermissibly following termination. Because the court characterized the deferred compensation provision as, in essence, a bonus for employees choosing not to compete, it is possible the court would reach a different conclusion if the arrangement had provided for voluntary deferrals.

For a further case in which a federal district court applied analysis akin to the employee choice doctrine, see Hay Group, Inc. v. Bassick, 2005 WL 2420415, 36 EBC 1369 (N.D. Ill. 2005). The case involved two Illinois executives. The court found that although the employer’s noncompetes were unreasonable under Illinois law, and therefore could not be enforced to prevent the former executives from competing, a forfeiture provision in the employer’s nonqualified deferred compensation plan was enforceable. Under that forfeiture provision, benefits were lost if the executives, within one year of termination, competed with the employer, disclosed confidential information, solicited employees to quit the employer, or solicited business from the employer’s clients. So, although the covenants not to compete (which in one case, prevented competition for a period of two years, and in the other case prohibited doing
business with any of the employer’s clients for one year – the latter of which the court found to be unreasonable because the employer had 7,000 clients, the executive had been in contact with only about 450 of those, and the executive had prior contact with some of the clients before beginning work with the employer) were unreasonable and unenforceable, the forfeiture provisions of the nonqualified deferred compensation plan were enforceable.

**Voluntary Termination**

The Seventh Circuit concluded that where an executive lost authority over one of two divisions she formerly controlled, and lost $6 million in independent spending authority, the executive’s voluntary termination was for “good reason” entitling her to severance benefits. The plan defined “good reason” as a “significant reduction in the scope of a Participant’s authority, position, title, functions, duties or responsibilities.” *Dabertin v. HCR Manor Care, Inc.*, 373 F.3d 822, 32 EBC 2825 (7th Cir. 2004).

The Sixth Circuit considered a former employee’s argument for an extended period to exercise stock options where the employee voluntarily terminated employment because he did not want to accept employment with a new joint venture in *Tredway v. Merck & Co., Inc.*, 225 F.3d 660, 25 EBC 2413 (6th Cir. 2000). Under the employer’s stock option plan, if the employee’s employment had been terminated at the employer’s initiative due to lack of work -- which the plan indicated could occur here the employer divested itself of a business which resulted in the employee’s termination -- the former executive’s options would have been exercisable for 12 months following termination of employment. The court found that the employee’s voluntary termination was not, in fact, a termination by the employer due to a lack of work, even though the employee’s decision to quit was precipitated by the creation of a new joint venture and the transfer of his employment to that new organization.

An executive was not entitled to severance benefits where, for family health reasons, he voluntarily resigned rather than relocate. *Jentz v. Minnesota Life Ins. Co. Employee Benefit Plan*, 2003 WL 22703219, 31 EBC 2635 (D. Minn. 2003). The plaintiff had been a regional vice president in Denver, but his employer closed its Denver office due to a company-wide reorganization plan. The executive did not request severance benefits at the time his position was eliminated, instead applying for a newly created position in San Francisco. The executive was offered the position in San Francisco and he accepted it. The new position required that the executive move to San Francisco within a few months following the assumption of his new duties. Due to health issues affecting his wife and an adult daughter, the executive resigned several months later rather than relocate his family members.

Among the events triggering severance pay under the employer’s plan were (1) an employee’s termination due to an inability to perform in a satisfactory manner not attributable to any willful cause and prior to being placed on performance probation, or (2) an employee’s termination due to elimination of the employee’s job or relocation of the employee’s office. The executive argued that he was entitled to severance pay under both of these triggers. The court disagreed. It concluded that the executive was not entitled to benefits under the first provision because his decision not to move to San Francisco was not based on his inability to do so, but instead because he chose not to do so for family reasons. That is, the executive’s resignation was based on a personal choice, which the court said was a willful decision. As to the second
provision, the court said the executive would have been entitled to severance pay had he requested it at the time his Denver post was eliminated under the reorganization. The executive did not, however, seek benefits at that time, instead applying for and accepting the new post in San Francisco. Because his last position was in San Francisco, not Denver, the executive was not entitled to severance benefits under the second provision.

[New Heading] **Termination Interfering with Earnout of Long Term Compensation**

The Eighth Circuit found that a former executive had no cause of action where his employer terminated his employment prior to the executive having the opportunity to maximize his awards under incentive arrangements. Importantly, the employee’s employment was at will and there was no implied guarantee that the former executive could maximize his awards. *Jenkins v. KLT, Inc.*, 308 F.3d 850, 29 EBC 1765 (8th Cir. 2002).


An employer was not, under the terms of executives’ separation agreements, required to include executives in an early retirement window adopted following their termination of employment. The early retirement window, which included a qualified pension plan sweetener, as well as improved medical coverage and a lump sum payment, was under consideration at the time the separation agreements were negotiated. Although the executives were terminated prior to implementation of the early retirement program, they had discussed with company representatives the possibility of their being included in the program under consideration. The separation agreements provided that the former executives would be included in the early retirement window program unless, in the company’s sole judgment exercised in good faith and based upon an opinion of the company’s legal counsel, the inclusion of the former executives in the program would result in a risk that the pension plan would be lose its qualified status. The company’s counsel opined that the inclusion of the former executives, without the inclusion of other former employees, did pose a risk that the pension plan would be disqualified and, therefore, the former executives were not provided with benefits under the early retirement window program. The executives argued that the company breached the separation agreements or, alternatively, breached its covenant of good faith and fair dealing in failing to either provide the former executives with the improved medical coverage and lump sum payment (but not the qualified pension plan sweetener), or to consider including other former employees in the early retirement program so as to avoid the risk of the pension plan’s disqualification.

The court concluded that the company did not breach the severance agreements, nor violate its covenant of good faith and fair dealing in satisfying its obligations under the agreement, because the agreements required the company only to obtain an opinion of counsel that the pension plan would be at risk of disqualification should the former executives be included in the early retirement window program. The company had no contractual obligation to consider alternative means for providing the former executives with some or all of the benefits provided under the window program. *Casey v. Semco Energy, Inc.*, 92 P.3d 379, 33 EBC 2361 (Alaska 2004).
[New Heading] Executive’s Breach of Fiduciary Duty

A state appeals court ruled that a former executive was not entitled to summary judgment on a claim that his former employer breached the terms of the executive’s employment contract by failing to pay him severance upon his involuntary termination in Prozinski v. Northeast Real Estate Services, LLC, 797 N.E.2d 415 (Mass. App. Ct. 2003). The executive was employed under the terms of a letter agreement, which clearly provided for the payment of one full year’s pay and severance upon the executive’s involuntary termination of employment. The employer, however, raised an affirmative defense and counterclaim that the executive was in material breach of his contract because he breached his fiduciary duty to the employer. Although not entirely clear, it appears the court implied a requirement that the executive not breach his fiduciary duty as a term of his employment agreement; the agreement itself did not seem to describe breach of a fiduciary duty as a breach of the employment agreement.

The court held that a finder of fact could conclude that the executive had committed a breach of fiduciary duty and, if so, could conclude that the breach constituted a material breach of the executive’s employment agreement excusing the employer from its contractual obligation to pay severance amounts. As to the executive’s conduct, the employer asserted that the executive had knowingly submitted false expense reports for his own purposes; fostered an environment within the workplace that was hostile to female employees; embarked on a course of sexual harassment of an employee; and used office computers to send obscene electronic mail and pornography.

The court also concluded that the severance pay was not subject to a Massachusetts wage payment statute requiring that an employee discharged from employment be paid in full on the day of his discharge. See M.G.L. c. 149 § 148, which generally requires the timely payment of “wages.”

A federal district court considered a company’s argument that post-termination benefits need not be paid to the company’s former CEO and chairman of the board due to the CEO’s breach of duties to the corporation, in Miller v. U.S. Foodservice, Inc., 361 F.Supp.2d 470, 35 EBC 1501 (D. Md. 2005). The CEO had resigned amid a scandal involving accounting irregularities which resulted in the overstatement of the company’s income by nearly $900 million over a period of a bit more than two years. The CEO sued when the company failed to pay to him certain post-termination benefits under his agreement with the company. The company counterclaimed, and the court considered the CEO’s motion to dismiss those counterclaims.

The court concluded that the company had successfully stated several claims. The first was a claim for breach of the fiduciary duty of care and good faith where, among other allegations, the company asserted that the CEO for a period of three years intentionally misled the company’s audit committee. The company alleged that the CEO misled that committee by indicating that internal controls were being corrected following the company’s receipt of a letter from its external auditor warning of deficiencies in the design and operation of those controls. The court concluded that the CEO did not enjoy any protection from this claim under the business judgment rule because the complaint concerned a failure to act (a failure to correct internal controls), not action.
The company also successfully stated a claim for breach of the CEO’s fiduciary duty of loyalty, due to the alleged intentional misrepresentation described above, the CEO’s conscious disregard of known risks, and his receipt of $750,000 in incentive compensation as a result of the overstatement of income. The $750,000 in incentive compensation was as much or more than the CEO’s annual salary.

In addition, the company successfully stated a contract claim for breach of the CEO’s employment agreement as a result of the fiduciary breaches. (The court’s decision does not make clear whether the employment agreement expressly incorporated the CEO’s fiduciary duties.) The court indicated that the remedy for such a contract breach could include the recovery of compensation, including bonuses and expense reimbursements.

The company brought a corporate waste claim against the CEO as well, to recover monies for personal expenses the executive had allegedly charged the company. In particular, the company alleged that the CEO received reimbursement for $130,000 in personal expenses not covered by his employment agreement, 45 percent of which were submitted and reimbursed without receipts; as well as membership fees and expenses for four country clubs, when the executive’s employment agreement only specified two; and another $236,000 in benefits including home improvement expenses, security services, and a Mercedes S Class sedan, which the company asserted were not covered by the CEO’s employment agreement. The court rejected the company’s claim, because the payments, even if unauthorized, had been approved by other officers or directors, which precluded a claim for waste.

The court also rejected the company’s unjust enrichment claim. It did so because there could be no such claim where there was an express contract, unless there were rescission of that contract. The court was unwilling to grant rescission of the agreement with the CEO because it considered that remedy inappropriate where, as in the instant case, damages could be calculated and because it would not seem possible to restore to the CEO the services he had provided to the company, as necessary under a rescission remedy.


A federal trial court concluded that an oral employment contract which included a promise of severance payments was not enforceable because it violated New York’s statute of frauds. *Andruff v. World Travel Holdings, PLC*, 2002 WL 1033811, 28 EBC 2268 (S.D. N.Y. 2002). The agreement violated the Statute of Frauds because it could be terminated (and therefore completed) within one year only if the former employee were to breach the contract during that timeframe. Where a defendant’s only means of terminating an oral contract within a year is predicated on the plaintiff’s breach, the contract is barred by the statute of frauds. The court acknowledged that there is a “narrow exception” to New York’s statute of frauds for situations where an employer expressly reserves the right to terminate an employee for “just cause,” but the court found no “for cause” provision in the agreement at issue.

[New Heading]  **Executive’s Failure to Return Retention Bonus: Unjust Enrichment**

In an unpublished decision, the Fourth Circuit considered a suit by WorldCom against a former executive for breach of contract and unjust enrichment, where the former employee
retained a retention bonus without fulfilling his obligation to remain employed by WorldCom for the required period of time. **WorldCom, Inc. v. Boyne**, 68 Fed. Appx. 447, 30 EBC 2550, 2003 WL 21465349 (4th Cir. 2003) (unpublished). Under the company’s retention program, certain executives received cash bonuses and stock options in return for their commitment to remain with the company for approximately two years. The CEO met with the plaintiff and approximately 100 other executives to discuss the retention program and testified that he told the executives they would be “receiving an envelope containing a retention bonus and stock options, and that the bonuses were conditioned upon the recipients remaining with the company” for approximately two years. The CEO testified that he emphasized any executive resigning prior to the end of the two years would have to return the cash bonus. The executives were not required to sign any legal document memorializing this understanding. Each executive’s retention package envelope did, however, contain a memorandum that the court thought made the executive’s employment commitment clear. The memorandum read, in part:

Cash award in the amount of __________ . . . . In return, I ask for your personal commitment to WorldCom through July 2002. In accepting this package, you commit to the company your continued employment through this date.

Several executives testified that when they left the meeting they clearly understood their repayment obligation.

The plaintiff received a check for $900,000, as well as a memorandum stating that he would be offered $900,000 and certain WorldCom stock options in exchange for his commitment to remain with the company through July 2002. The executive voluntarily terminated his employment prior to July 2002, but refused to return the cash bonus upon WorldCom’s demand. To offset the amount the company believed the executive owed it, WorldCom suspended the executive’s right to exercise certain vested stock options. It also rescinded the executive’s final paycheck. The court affirmed the trial court’s decision that the former executive was required to return the cash bonus under an unjust enrichment theory.

[New Heading] **Retention Agreement: Continued Employment as Consideration**

A Mississippi appeals court concluded that the continued employment by an at-will employee was adequate consideration to support the employer’s contractual obligation to make payments under a retention agreement. **Marshall Durbin Food Corporation v. Baker**, 909 So.2d 1267, 2005 WL 351314 (Miss. App. 2005) (unpublished). The court viewed the agreement as a unilateral contract which the employee, the company’s former president, could accept by continuing employment.

[New Heading] **ERISA Preemption**

In a change in control decision, a state appellate court held that a former executive’s promissory estoppel claim was preempted by ERISA. The executive complained that he quit his job and lost out on benefits under a change in control severance program because the company’s CEO falsely represented that the company would not be sold. **Cornelison v. Pioneer Hi-Bred International, Inc.**, 674 N.W.2d 684, 32 EBC 1390 (Iowa Ct. App. 2003) (unpublished).
A federal district court concluded that a state law claim that the involuntary termination of an executive was a breach of contract was not preempted by ERISA, even though the damages claimed were, primarily, the value of benefits denied under the “for cause” termination provisions of a nonqualified deferred compensation plan and executive severance plan. *Grover v. Comdial Corp.*, 275 F.Supp.2d 750, 30 EBC 2878 (W.D. Va. 2003). The plaintiff successfully argued that his claim was not preempted because he asserted only that the employer wrongfully caused a denial of benefits by terminating the executive; he did not make a claim that either of the plans was improperly administered. The claim was not preempted even though the executive apparently contended that the employer decided to terminate him for cause for the purpose of interfering with his right to claim benefits. It seemed critical to the court that the executive’s claims were made against the employer for breach of an employment contract (the decision does not make clear whether this employment agreement was written), rather than being made against the plans for failure to follow the plans’ terms.

The context for the decision was procedural. The employer was attempting to remove the action from state to federal court, arguing that the executive’s breach of contract claim was (completely) preempted by ERISA and as such would justify the exercise of federal question jurisdiction. In fact, the court had previously ruled on a similar removal request and, notwithstanding some change in the executive’s arguments, the court found that the executive had not raised any new federal question justifying the second removal petition. The prior denial of the employer’s removal petition was, therefore, considered the law of the case.

State breach of contract and state wage payment claims for severance were not preempted where the severance provisions of an executive’s offer letter, which served as the executive’s employment agreement, did not provide for benefits under the employer’s ERISA-governed severance plan. *Gresham v. Lumbermen’s Mutual Casualty Company*, 2005 WL 844728 (4th Cir. 2005). The court, in reaching this conclusion, found it notable that benefits under the more formal severance plan would have been smaller in amount and would, in contrast to the terms of the executive’s employment agreement, not have been payable were the executive offered employment by an acquiring company.

[New Heading] **Severance: Application of ERISA**

A severance provision of an executive’s employment agreement, which provided for paying one-year’s base salary if the executive were terminated without cause, did not create a plan subject to ERISA. *Gresham v. Lumbermen’s Mutual Casualty Company*, 2005 WL 844728 (4th Cir. 2005). The court found that state breach of contract and state wage payment claims for severance were not preempted because the severance provisions of the executive’s offer letter, which served as his employment agreement, did not provide for benefits under the employer’s ERISA-governed severance plan. The court, in reaching this conclusion, found it notable that benefits under the more formal severance plan would have been smaller in amount and would, in contrast to the terms of the executive’s employment agreement, not have been payable were the executive offered employment by an acquiring company.
Executive’s Failure to Provide Release

A former chief executive officer was not entitled to severance compensation worth approximately $3 million where the executive failed to provide the employer with a general release required under his employment agreement as a prerequisite to eligibility for severance compensation. *Kaul v. Hanover Direct, Inc.*, 296 F.Supp.2d 506, 32 EBC 1222 (S.D. N.Y. 2004). Although the former CEO did deliver a release to the employer, it contained a number of exceptions for claims he wished to prosecute under the terms of the employment agreement.

Similarly, where executives tendered releases upon their discharge from employment, but did not do so in the form required under the terms of a severance plan, the executives were not entitled to benefits under the severance program. *Bender v. Xcel Energy, Inc.*, 2005 WL 1774034, 36 EBC 1569 (D. Minn. 2005).

The Sixth Circuit allowed an employee to sign a release that was a condition of receiving severance payments later than the plan’s established deadline for doing so, where the employer had previously rejected the employee’s timely release. *Godleski v. FirstEnergy Corp.*, 477 F.3d 403, 39 EBC 2729 (6th Cir. 2007). The severance plan required that participants who were told they were being offered benefits sign a release of all claims against the employer. The employer failed to accept the plaintiff’s release because in the interim he obtained employment with a related company, which at least arguably made him ineligible for benefits. The employee subsequently followed the plan’s claims and appeals process. The administrative committee hearing the appeal denied the employee’s claim on the ground that he failed to timely submit a signed release. The court held that the employee was not required to sign a release until after benefits were offered (which, in this case, had not occurred prior to the court’s ruling, because the employer had denied benefits after initially offering them), reasoning that it would make no sense to require a person to sign a release when it was as yet unclear whether he or she would be entitled to benefits. As a result, the participant was entitled to severance pay. The opinion is puzzling, in part, because it does not seem to address the apparent inconsistency between the administrative committee’s conclusion that the participant failed to timely provide a release and the court’s indication that the employee in fact had tendered a release which the employer refused to accept because it believed the employee was ineligible for benefits due to an offer of subsequent employment.

Exhaustion of Remedies

An executive’s claim for benefits under a change of control provision of a severance plan subject to ERISA was dismissed for failure to exhaust the executive’s administrative remedies under the plan before bringing suit. *Stark v. PPM America, Inc.*, 354 F.3d 666, 31 EBC 2864 (7th Cir. 2004). The court concluded that the proper remedy for failure to exhaust was dismissal of the case, rather than requiring the plaintiff to avail himself of the plan’s administrative procedure. The court, in explaining the dismissal, said:

[The executive] cannot be allowed to skip the administrative procedure, cause the defendants to incur litigation costs, and then, after losing, be allowed to exhaust his remedies.
Disclosure of Executive’s Misconduct: Defamation and Contract Claims

A former CEO and chairman of a company brought defamation and contract claims based on the company’s disclosure of the executive’s alleged misconduct in *Kamfar v. New World Restaurant Group, Inc.*, 347 F.Supp.2d 38 (S.D. N.Y. 2004). The Company had retained a law firm to thoroughly investigate whether $3.5 million in bonuses paid to the CEO and two other executives (the CFO and General Counsel) were authorized by the board. The portion received by the CEO was alleged to be approximately $1.6 million. The law firm reported to the board that the bonuses were not authorized. Although the board’s compensation committee had discussed the compensation at issue, the board had never acted in approving the compensation. The law firm advised the board that the Company’s financial statements must, as a consequence, be restated.

The Company then entered into an agreement with the CEO to resign, repay his bonus of approximately $1.6 million, and receive severance pay in the amount of approximately $1.4 million. The agreement included mutual covenants not to make disparaging remarks, not to sue, and to keep the terms of the agreement confidential.

The Company issued a press release announcing the CEO’s departure and the severance payments. The 10-K filed by the Company indicated that the bonuses were unauthorized, but did not disclose the parties to whom the bonuses were paid. A company representative, however, told a reporter that the CEO was one of those who had received the bonuses at issue. The reporter’s newspaper then published this information. Although the law firm had advised the board that the securities laws required disclosure of the circumstances underlying the restatement and the $1.4 million payment to the CEO, it did not advise that the identity of the recipients of the bonuses must be disclosed.

The court made several rulings. First, the court held that, under New York law, although the matter involved “private figure” defamation, the CEO was suing on a statement that was “arguably within the sphere of public concern” (which the CEO conceded). In this circumstance, a successful plaintiff must show that the defendant “acted in a grossly irresponsible manner, without due consideration for the standards of information gathering and dissemination ordinarily followed by responsible parties.” The CEO failed to show that the Company acted with gross irresponsibility in publicly characterizing the bonuses as unauthorized. The court cited a number of New York cases where companies’ reliance on thorough, responsible internal investigations of potential employee misconduct defeated defamation claims when the results of the investigation were published.

Second, the court concluded that the Company did not breach the confidentiality provisions of its agreement with the CEO because whether the bonus was authorized was not a term of the agreement. Instead, the agreement prohibited disclosure of the terms of the agreement and the agreement did not itself describe the bonus as unauthorized.

Third, the court refused to grant summary judgment for the Company on the CEO’s claim that the Company breached the agreement’s nondisparagement provision. Although the agreement prohibited disparagement of the parties by one another, it did allow the Company to make disclosure to the extent the Company, in good faith, believed disclosure to be necessary or
desirable to protect the Company’s interests. The court held that it was unclear whether the disclosure that the bonuses were unauthorized was the product of good faith reliance on the advice of counsel.

Finally, concerning the CEO’s covenant not to sue, the court found that there was no exception permitting the CEO to bring a tort claim or a declaration (which the CEO requested of the court) that the bonuses were authorized. Nevertheless, the court refused to award the Company attorneys’ fees as a remedy for the CEO’s breach of the covenant not to sue because absent a clear intention to the contrary set forth in an agreement, parties can only use a covenant not to sue as a defense or to establish liability where suit is brought in obvious breach of the contract or otherwise in bad faith. The court found that the CEO’s suit was not in obvious breach of the contract nor in bad faith. The covenant not to sue did not, incidentally, interfere with the CEO’s ability to enforce the terms of the agreement, so the CEO’s claim for breach of the agreement’s nondisparagement provision could continue.

[New Heading] Release: Section 510 Claim Waived

A former executive waived any Section 510 claim he may have had for being terminated to interfere with his rights under what was apparently a nonqualified deferred compensation plan. *Hannah v. American Republic Insurance Company*, 416 F.Supp.2d 605 (W.D. Tenn. 2006). The former executive’s argument that a release he signed was invalid because he entered into the agreement due to economic duress was rejected. Although the executive alleged he signed the release involuntarily due to his economic exigencies and uncertainty about whether the employer would honor its compensation commitments, the plaintiff did not allege wrongful or oppressive conduct by the employer as required under Iowa law to invalidate a release as a result of economic duress. (The parties agreed that Iowa law would apply.)

[New Heading] Separation Agreement: Characterization of Termination, Equity Compensation, Fraud

The characterization in a separation agreement of a termination of employment being without cause controlled the vesting of equity compensation, even though the employer in fact did not terminate the employee on the date designated in the agreement due to the employee becoming entitled to disability benefits in the interim. *Healy v. MCI WorldCom Network Service, Inc.*, 2005 WL 1837148 (E.D. Cal. 2005), motion for reconsideration denied, 2005 WL 2000862 (E.D. Cal. 2005).

The executive had entered into a separation agreement and general release on September 10, 1998, under which the employee would be terminated on December 31, 1998. Under the agreement, the company was to pay the executive a lump sum amount of $262,500 within 10 days of termination. The termination was to be treated, for purposes of the company’s “Incentive Stock Unit” plan, as a termination without cause.

The company knew that the executive had talked from time to time about the possibility of applying for disability benefits. When the executive mentioned this in the month prior to entering into the separation agreement, he was told by company representatives that if he went
on disability leave prior to his anticipated termination date of December 31, 1998, he would not be terminated because the company did not terminate employees while on disability leave.

The executive nevertheless began receiving disability benefits in December 1998, prior to his scheduled termination date. The company took the position that the executive was, therefore, not yet due a lump sum payment under his separation agreement, because his employment had not been terminated and would not be terminated until he returned from disability.

The court found the terms of the separation agreement to be ambiguous and held that, despite the company’s policy of not terminating employees while on disability leave, the company was required under the terms of the separation agreement to terminate the executive on December 31, 1998, and pay to him the lump sum amount set forth in the agreement. The court awarded to the executive prejudgment interest on this amount at an annual rate of 10 percent.

The court was also required to determine when incentive stock units vested. The incentive stock unit program permitted employees to defer a portion of their incentive pay. The company matched 25 percent of the amount deferred. The deferred amounts were used to purchase company stock. In general, the units vested over a period of three years, with one-third vesting each year. In the event of disability, a participant was considered to remain employed, and continued to vest according to the plan’s vesting schedule. In the event of a termination without cause, however, vesting was accelerated.

The court found that the separation agreement unambiguously provided that termination on the scheduled date was to be considered a termination without cause, which resulted in immediate vesting of the executive’s incentive stock units. The ISU provision concerning continued application of the vesting schedule in the event of disability was held inapplicable.

In a subsequent decision, the court considered the employee’s fraud claims. Healy v. MCI WorldComm Network Service, Inc., 2006 WL 1167458, 37 EBC 1724 (E.D. Cal. 2006). The court concluded that there were two instances of intentional misrepresentation supporting fraud claims. The first was a statement by the Vice President of Human Resources that she had checked with the legal department and that she had been told by the legal department that the employee could not be discharged while he was on disability. The court concluded that this statement was intentionally false.

The second false statement was a representation by an attorney at a successor employer that had purchased the company, who indicated in a letter to the former employee that the successor had no liability relative to the separation agreement. The court concluded that the attorney knew this was an intentional false statement which the successor company intended the former employee to rely on. The statement was false because the successor and original employer were jointly and severally liable for the benefits due under the separation agreement. The court awarded damages for fraud, including damages for pain and suffering and punitive damages.

On appeal, the Ninth Circuit affirmed the fraud claim against the successor employer, although it noted that the evidence of justiciable reliance was “thin.” Healy v. MCI WorldComm Network Services, Inc., 2007 WL 465763 (9th Cir. 2007). The appeals court reversed, however,
the fraud claim against the original company. That is because in California, for an employee to have an independent fraud claim against his or her employer, the misrepresentation at issue cannot be aimed at effecting termination or retention of employment, but must instead be aimed at inducing an employee to detrimentally alter his position in some other respect. In the instant case, the district court had concluded that the former employee could maintain a fraud claim based on his employer’s failure to terminate him. At the time of the Vice President for Human Resources’ false statement both the Vice President and the plaintiff were employees. Therefore, the fraud claim based on the Vice President’s statement was a claim against the original employer based on the same conduct that formed the basis of the plaintiff’s breach of contract claim, namely the failure to terminate the plaintiff. The fraud claim against the original employer was, therefore, dismissed.


The Third Circuit held that an agreement entered into under an ERISA-governed severance plan was to be construed under the federal common law of contracts, not state law. Koenig v. Automatic Data Processing, 156 Fed. Appx. 461, 37 EBC 1254 (3d Cir. 2005) (unpublished). The district court below had, instead, applied New Jersey law to require the payment of severance benefits and the extension of time to exercise stock options even though the executive failed to notify his former employer of new employment. The district court held that the denial of severance benefits and extension of time to exercise options was a prohibited penalty under New Jersey law. The Third Circuit instructed the district court, on remand, to apply federal common law to determine whether there was a breach of contract and, if so, whether that breach was material.

[New Heading] Section 510: Termination Prior to Early Retirement Eligibility

A long-term employee failed to establish a prima facie case of a Section 510 violation merely by reason of the employee being terminated pursuant to a reduction in force three years before the employee would have become eligible for early retirement benefits. Soliday v. Fluor Fernald, Inc., 2006 WL 143381 (S.D. Ohio 2006). Although “close temporal proximity” of the date of an employee’s termination to the date of benefit eligibility may sometimes make out a prima facie case of a Section 510 violation, the court concluded that a gap of three years was too great to do so absent “additional, highly probative facts that suggest intentional discrimination.”

[New Heading] Severance: “Comparable” Position

An executive who was terminated in connection with an asset sale was estopped from arguing that he was entitled to severance payable in the event the buyer did not offer him a “comparable” position. The executive was estopped because he had accepted a “go with buyer” benefit from the seller that was itself payable only in the event the executive were offered a comparable job with the buyer. (The executive did, in fact, become an employee of the buyer.) Magin v. Monsanto Company, 420 F.3d 679, 35 EBC 2182 (7th Cir. 2005). The court’s analysis is a bit difficult to follow, but it appears the executive was estopped even though the severance plan at issue did not define the term “comparable,” while the “go with buyer” benefit seemed to define a “comparable” job simply as one providing the same base pay. Notably, the severance plan document provided that benefits would be payable only if the buyer did not offer...
employment. It made no mention of the need for that employment to be in a comparable position. Only a summary of the plan added the term “comparable.”

A former executive who claimed he was entitled to severance benefits because he was not offered a “comparable position” on the sale of his employer survived a motion for summary judgment in Pelosi v. Schwab Capital Markets L.P., 462 F.Supp.2d 503, 40 EBC 1832 (S.D. N.Y. 2006). The executive’s claim survived the summary judgment motion even though the plan provided that whether there was an involuntary termination on account of a change in the company’s operations or organization was to be “determined by the administrator in its sole discretion,” and even though the plan’s definition of a “comparable position” indicated that “the administrator shall have the sole discretionary authority to determine whether a position is a ‘comparable position’ under this paragraph taking into account such factors as it deems appropriate including without limitation the similarity of duties, similarity of exempt or nonexempt status, salary range and any increase in the commuting distance to the employee’s principal place of employment.” The executive alleged that the offered position was not comparable because it guaranteed only 10 percent of his former salary, required him to move, and included a noncompete provision. The court seemed to suggest that the administrator would need a reasonable basis for its determination that the offered position was comparable despite the very broad discretion granted it under the plan’s terms.


The court in Magin, supra, also addressed the benefit to which the executive was entitled under the buyer’s severance plan when the executive was later terminated from that company. The buyer had obligated itself in the asset purchase agreement to provide the same (or greater) severance benefits as those available under the seller’s program, should the executive (or certain other employees hired in connection with the asset purchase) be terminated without cause by the buyer within 12 months of the purchase. The executive was, in fact, terminated without cause within 12 months of the purchase. He argued that he was entitled to the enhanced severance benefits available under the seller’s severance plan to employees who sign a waiver of claims. The court rejected the executive’s argument because the buyer was not obligated to offer the executive the opportunity to sign a waiver (again, signing a waiver was a prerequisite to receiving enhanced benefits under the seller’s plan). And the buyer did not, in fact, offer the executive such an opportunity. Although it does not seem to have been the basis for the court’s decision, it is notable that the buyer, in the purchase agreement, obligated itself only to provide the base severance benefit provided under the seller’s severance plan. This, presumably, would not have included the “enhanced benefits” available under the seller’s plan in exchange for a waiver of claims.


A federal district court considered a former employee’s fiduciary claims against his prior employer concerning alleged promises about benefits to be provided to employees hired by an outsourcing vendor in Engler v. Cendant Corp., 434 F.Supp.2d 119, 38 EBC 1879 (E.D. N.Y. 2006). The plaintiff’s prior employer apparently entered into an agreement to outsource certain functions to IBM. The former employee alleged that in connection his offer of employment with
IBM, his prior employer (and then current employer) sent him a letter, which at least arguably indicated that IBM would count service with the prior employer under IBM’s pension plan and, the employee apparently alleged, for purposes of other benefits as well. In fact, upon the plaintiff’s later termination of employment from IBM, severance pay and extended health coverage under IBM’s benefits plan were determined without counting prior service with the plaintiff’s original employer.

The court first considered whether the employee was required to exhaust administrative remedies in connection with his ERISA claims against IBM. The court held that there was no need to exhaust his administrative remedies if, as he alleged, IBM failed to give him written notice of the denial of his claim. The court did not get to the merits of the employee’s claims against IBM in its ruling on the defendant’s motion to dismiss for failure to state a claim.

The court then considered the plaintiff’s fiduciary claim against his prior employer. The court concluded that the former employee had no fiduciary claim against his prior employer in connection with letters it wrote to the plaintiff concerning benefits to be provided at IBM. That was because the plaintiff failed to allege a relevant plan with respect to which his former employer was a fiduciary. In that regard, the court noted that the plaintiff was seeking benefits under an IBM plan, and his prior employer was not a fiduciary with respect to that plan.

[New Heading] **Golden Parachute: Overlapping Shareholders**

There was a change in the ownership of a substantial portion of a company’s assets within the meaning of the golden parachute provisions of Internal Revenue Code Sections 280G and 4999 where all of the company’s assets were contributed to a new joint venture and the parent of the contributing company received a 43 percent ownership interest in the joint venture. *Yocum v. United States*, 66 Fed. Cl. 579, 36 EBC 1385 (Cl. Ct. 2005). The executive unsuccessfully claimed that there had not been a change in ownership by reason of the exception set forth in Treasury Regulation Section 1.280G-1, Q&A 29, applicable to asset transactions where the transferor and transferee companies have overlapping shareholders and the shareholders of the transferor company retain at least a 50 percent interest in the transferee entity. The executive was unsuccessful in making this argument because he could not count toward the requirement that the transferor company’s shareholders retain at least a 50 percent ownership interest in the transferee company the ownership those shareholders (actually, the shareholders of the parent) had in the other joint venture owner. That is, the executive could not consider the shareholders of the parent to be individuals acting as a group, and thereby be able to add their interests in the parent to their interests in the other joint venture owner for purposes of the 50 percent exception, absent some evidence that the shareholders did actually act as a group through concerted or coordinated action.

[New Heading] **Garnishment of Retirement Benefits: Criminal Restitution**

ERISA’s anti-alienation provision offers no protection from the garnishment of retirement accounts to enforce a criminal restitution order. *United States v. Irving*, 2006 WL 1735582 (2d Cir. 2006). The court found that the Mandatory Victims Restitution Act of 1996 (the “MVRA”) overrides the anti-alienation provisions of ERISA Section 206(d). In particular, 18 USC Section 3613(a) permits the enforcement of a judgment imposing a fine or an order of

In an en banc rehearing, the Ninth Circuit engaged in a more nuanced analysis than the Second Circuit in Irving. U.S. v. Novak, 476 F.3d 1041, 39 EBC 2825 (9th Cir. 2007). The Ninth Circuit agreed with the Second Circuit that the MVRA overrides the anti-alienation provisions of ERISA § 206(d), but held that this only allows the government to “step into the defendant’s shoes.” As a result, the government can immediately garnish the corpus of a retirement plan to satisfy an MVRA judgment if, but only if, the terms of the plan allow the defendant to demand a lump sum payment at the present time. In contrast, if a defendant, for example, were entitled to benefits under a defined benefit pension plan that provided only for annuity payments, with no accelerated payment option, the government could only garnish those payments as and when they become available to the defendant. The court noted that one implication is that if a plan includes a lump sum option, but ERISA requires that lump sum payments be made payable only with spousal consent, the government would need spousal consent to cash out a defendant’s benefits.

[New Heading]  
**Severance: Elimination of Position or Reduction in Force**

Under an arbitrary and capricious standard, a district court upheld the severance plan administrative committee’s denial of severance benefits to an executive who asserted he was involuntarily terminated. Although the employer disputed whether the termination was involuntary, or whether the executive instead quit, this determination was unimportant because benefits were payable under the severance program only where termination was due to the elimination of a severance plan participant’s employment position or a reduction in size of the employer’s workforce. The executive failed to produce evidence to establish that either had been the case. Allen v. Baxter International Inc., 2006 WL 560608, 37 EBC 2843 (N.D. Ill. 2006). On a procedural matter, the court allowed the executive to sue the company, rather than the plan as an entity. The court allowed the executive to proceed against the company as the named defendant instead of the plan because there were indicia that the plan and the company were closely intertwined (citing Mein v. Karus Corp, 241 F.3d 581, 25 EC 1961 (7th Cir. 2001); Riordin v. Commonwealth Edison Co., 128 F.3d 549 (7th Cir. 1997)). The court ruled, however, that the plan’s administrative committee, which served as the plan administrator, was not a proper defendant.

[New Heading]  
**Split Dollar Life Insurance: Collateral Assignment, Employer’s Rights Extinguished by Employment Release**

A state court of appeals concluded that a mutual release between an employer and former employee caused the employer to lose its right to recover premiums it had paid under a collateral assignment split dollar life insurance agreement. Goldring v. Franklin Equity Leasing Co., 195
S.W.3d 453 (Mo. Ct. App. 2006). The release was executed in connection with the employee’s termination of employment and provided that the parties generally released one another from all claims. Because of the broad scope of the release, it extinguished the employer’s right to recover premiums paid under the split dollar agreement.

[New Heading] **Severance Benefits: Change of Control, Comparable Benefits, Failure to Offer Stock Options**

The Sixth Circuit considered whether an offer of employment which failed to include stock options constituted an offer of “comparable benefits” for purposes of severance pay eligibility, in *Kolkowski v. Goodrich Corp.*, 448 F.3d 843, 37 EBC 2249 (6th Cir. 2006). The severance plan at issue provided involuntary termination benefits upon a change of control. An employee was not, however, entitled to severance pay if the acquirer offered “comparable benefits,” as compared with the benefits provided by the employer prior to the sale. In particular, if an employee was offered employment by the buyer with no reduction in base salary, and benefits were comparable to those prior to the change of control, the employee would not be entitled to severance pay.

In determining whether the former employee had been offered comparable “employee benefits,” the court held that stock options were “employee benefits.” As a result, the failure of the offer to include an offer of stock options meant the former employee did not receive an offer of comparable employee benefits and was therefore entitled to severance pay. The court based its holding on its conclusion that the common understanding of the term “employee benefits” includes stock option plans and because the summary of the severance plan provided that “the plan’s benefits are in addition to, and do not affect, any other benefits to which a covered employee may be entitled, such as benefits under the . . . stock option . . . plans.” The court noted that the quoted language seems to refer to stock options as “benefits,” and that the average participant would think that the term “employee benefits” as used in determining whether a comparable offer had been made, would mean the same thing.

[New Heading] **Disability Benefits: Counting Stock Option Compensation**

A federal district court concluded that in determining compensation for purposes of calculating disability benefits, stock option compensation should be included. *McAfee v. Metropolitan Life Insurance Co.*, 2006 WL 1455431, 38 EBC 2653 (E.D. Cal. 2006). The court, applying an abuse of discretion standard, concluded that the insurer incorrectly excluded performance-based stock option compensation from pre-disability earnings for purposes of calculating the amount of disability benefits. The plan referred to pre-disability earnings in terms of “gross salary or wages,” and listed as one example “performance bonuses.”

[New Heading] **Severance Benefits: Complete Preemption, Quantum Meruit Claim**

A former executive’s state law quantum meruit claim, alleging that her former employer was unjustly enriched by failing to pay severance benefits, was completely preempted in *Curcio v. Hartford Financial Services Group*, 469 F.Supp.2d 239, 40 EBC 2025 (D. Conn. 2007). As a result, the executive’s claim was removable to federal court. The court held that the claim was
completely preempted under the Supreme Court’s guidance in *Aetna Health Inc. v. Davila*, 542 US 200, 32 EBC 2569 (2004), because (a) the executive could have brought her claim as an ERISA Section 502(a)(1)(B) claim for benefits, and (b) the employer’s alleged liability was derived from or dependent on the existence of the administration of an ERISA-regulated severance plan so that there was no legal duty independent of ERISA implicated by the employer’s actions.

**[New Heading] Release: Counting Stock Option Compensation Under Retirement Plans**

An executive’s waiver of claims prevented the executive from arguing that compensation from the exercise of stock options was to be counted as compensation for purposes of determining benefits under a qualified retirement plan and a top-hat SERP. *Linder v. BYK-Chemie USA, Inc.*, 2006 WL 648206, 38 EBC 2493 (D. Conn. 2006). The court held that a waiver of claims against the employer was also a waiver of any claim that income on the exercise of stock options was compensation under a top-hat plan. This was true even though no waiver of claims against the plan as a defendant was expressly given. The waiver given the employer protected the plan as well since the court concluded that the employer is the real party-in-interest in a claim involving benefits under an unfunded arrangement such as a top-hat plan, with the plan being only a nominal defendant. As a result of the executive’s knowing and voluntary waiver, releasing the employer from all claims (including claims arising under or in connection with the executive’s employment), executed at a time when the executive knew that the issue of whether compensation from the exercise of stock options was included in compensation under the top-hat plan was unresolved, the executive waived any claim that the option income was to be includable as compensation for that purpose. The court also held that the employer did not waive any claim that the executive had released his claim by failing to raise the matter during the administrative review process, where the claims review process was never completed and therefore the executive’s claim was deemed denied. Finally, the court concluded that ERISA’s anti-alienation provision does not prevent a waiver of benefits where there is a contested benefit claim.

**[New Heading] Bonus Compensation**

**[New Heading] Unjust Enrichment: Bonus Repayment Required**

The former CEO and Chairman of the Board of Directors of HealthSouth Corporation was required to repay $47 million in bonuses and prejudgment interest in *Scrushy v. Tucker*, 2006 WL 932013 (Ala. 2006) (unpublished). *Scrushy* was a shareholder derivative action brought against HealthSouth’s former CEO in the aftermath of the company’s accounting scandal. Shareholders made allegations of insider trading, fraud, breach of fiduciary duty, and unjust enrichment. The Supreme Court of Alabama concluded that target bonuses paid to the former CEO were payable only if the corporation had annual net income. It resolved an ambiguity in that regard, in part, by reference to the company’s annual proxy (Form 14A) in which the company indicated that an incentive bonus pool provided the funds from which all bonuses were to be awarded, and the form stated that bonuses were payable only when the company had annual net income. The CEO had argued that the target bonuses, which were payable pursuant to his employment contract, were independent of the annual incentive bonuses available to senior management. Because the company, in fact, had no annual net income after
correction for accounting irregularities, the court concluded that the bonus monies would, whether under Delaware or Alabama law, in equity and good conscious, need to be repaid to the company because the former CEO had been unjustly enriched by the payment of bonuses which were the result of a “vast accounting fraud” perpetrated upon the company and its shareholders. The company required the former CEO to repay the gross amount of the bonuses awarded, rather than the net after-tax amount he received.

The Wall Street Journal reported that the CEO and Chairman of the Board of FPL Group, Inc. (the parent company of Florida Power & Light Co.), and other executives agreed to repay over $22 million of $62 million in incentive compensation they received in connection with the shareholder approval of a merger with Entergy Corp. “Companies Discover It’s Hard to Reclaim Pay From Executives,” Wall St. J., Nov. 20, 2006, p. A1. Despite shareholder approval, the merger never actually occurred. The company’s change of control provisions, however, nevertheless provided for the vesting and cashout of performance-based awards upon shareholder approval of a merger, whether or not the merger were actually to occur. The shareholder approval apparently triggered payments of $92 million in cash payments to nearly 700 managers. The reported repayment of over $22 million of the $62 million paid to certain key executives was part of a settlement that followed a district court’s refusal to dismiss a shareholder derivative action asserting that the proxy statements with respect to the long-term incentive plan were materially false and misleading, and challenging the payments made under the plan as involving corporate waste. Klein v. FPL Group, Inc., 2004 WL 302292 (S.D. Fla. 2004). As part of its ruling, the court concluded that the Evaluation Committee appointed by the board to determine whether to pursue an action on the corporation’s behalf, and the board members who collectively voted to terminate the derivative action, did not establish by a preponderance of the evidence that they were independent at the time they made their determination. In that regard, the members of the Evaluation Committee and the board who decided not to pursue the shareholder derivative claims were the very individuals who had been involved in approving the transactions at issue and were defendants in the current action. The Wall Street Journal reported that of the roughly $22 million returned, the executives paid almost $10 million of that amount, with insurers covering the rest.
CEOs Beware: Don’t Overreach in Comp Negotiations

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The ongoing Disney litigation has focused attention on the proper role of board members in setting and approving executive compensation. But what about the role of the executive in that process? May she bargain hard? Are there legal limits on an executive’s attempts to influence board members on compensation decisions affecting her? A recent court decision helps answer these questions and should serve as a warning to CEOs and other high level executives owing a fiduciary duty to their companies.

In the court decision, Official Committee of Unsecured Creditors of Integrated Health Services, Inc., v. Elkins, 2004 WL 1949290 (Del. Ch. 2004), the Delaware Court of Chancery applied principles established in In Re The Walt Disney Co. Derivative Litigation, 825 A.2d 275 (Del Ch. 2003), to claims that a CEO acted improperly in influencing his company’s board of directors in setting the CEO’s compensation. It did so in the context of a motion to dismiss claims brought by an unsecured creditors’ committee of the bankrupt employer. Because it was considering a motion to dismiss, the court assumed that the facts alleged by the creditors’ committee were true. The creditors’ committee argued that the founder and CEO of the company breached his fiduciary duties of loyalty and good faith to the company by obtaining certain compensation arrangements without regard to the best interests of the company, and by using his various positions at the company to exert improper influence over other members of the board (the CEO himself was a board member) and over the board’s compensation consultant.

The creditor’s committee alleged, in essence, that the board blindly approved whatever compensation the CEO requested. That compensation allegedly amounted to at least $40 million over a period of about five years. During this time, the company’s stock fell in value and the company ultimately declared bankruptcy.

The court’s analysis of the propriety of the board’s actions is of note, but the more important lesson may be the guidance the decision offers to CEOs and other very high level executives. The court summarized the special rules which apply to CEOs and other employees with a fiduciary obligation to their companies as follows:

In general, employees negotiating employment agreements with their employers have the right to seek an agreement containing the best terms possible for themselves. However, once an employee becomes a fiduciary of an entity, he has a duty to negotiate further compensation agreements "honestly and in
The court found that the creditors’ committee’s allegations, if true, could indicate that the CEO had breached his duty of loyalty and improperly engaged in a self-interested transaction. In reaching this conclusion, the court relied on a list of alleged facts concerning the CEO’s claimed control over the board. In particular, the creditors’ committee asserted that the CEO set out agendas for the board and compensation committee meetings; attended those meetings; spoke with directors outside of the meetings; negotiated his compensation packages with the board and compensation committee; and spoke with the board’s compensation consultant. The court said taken individually none of these actions would be enough to show a breach of the CEO’s duty of loyalty. However, these allegations, when coupled with allegations that the CEO reviewed and revised every draft of the compensation consultant’s reports before they were submitted to the board; the CEO exerted pressure on the compensation consultant to justify the CEO’s compensation; a letter the CEO wrote to the board inaccurately stated facts as to what the compensation committee had previously approved in terms of forgiveness of loans to the CEO (much of the compensation at issue concerned loans and their forgiveness); the CEO caused the company to disburse funds to him without corporate authority; the CEO insisted on a loan program in anticipation of an outside lender eliminating the company’s use of its credit agreement to provide loans to employees; and the CEO insisted on extending a loan forgiveness program to all of his loans, notwithstanding opposition by the compensation consultant; suggest that the CEO “may have breached his fiduciary duties by engaging in a self-interested transaction.”

The court rejected the CEO’s argument that compensation committee or board approval eliminated any breach of the duty of loyalty. Instead, if the CEO in bad faith manipulated the process of the compensation committee or board approval itself, the CEO could not benefit from the decisions reached through that process.

**Lessons.** The *Elkins* decision, though only a ruling on a motion to dismiss, is a warning to CEOs and other high level executives having a fiduciary duty to their companies. To avoid committing a breach of his or her duty of loyalty, a CEO (or other executive with a fiduciary obligation to the company) should negotiate his or her compensation in an arms-length manner, in good faith, and not in an attempt to advantage the CEO at the expense of the company’s shareholders.

It is one thing to state these principles and another to know how they should apply in particular factual circumstances. The bottom line is probably that a CEO will not breach his or her duty of loyalty to the company in seeking compensation if (a) the compensation is within a reasonable range, given the CEO’s and company’s performance, (b) the CEO does not dominate the board, but instead the board and compensation committee act in a disinterested and independent fashion, and (c) the CEO keeps his or her distance from board and compensation committee deliberations on compensation, and does not individually lobby members of the board, its compensation committee, or their advisors on issues relating to the CEO’s compensation, but instead discusses compensation only in a formal and open manner with the board, compensation committee, or other party appointed to negotiate with the CEO.

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Tell the Truth!

by

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Telling the truth is always good. It seems, though, that telling the truth about the present may be more important than telling the truth about one’s intentions for the future. Courts – and some people – will grant you a little more leeway to puff about your plans for the future than to strain the truth about a current, verifiable state of affairs. This principle of human nature – and legal practice – is well illustrated by a recent case decided by the federal trial court for the Northern District of Illinois, Bors v. Duberstein, 2004 WL 1588271, 33 EBC 1893 (N.D. Ill. 2004).

In Bors, an executive complained that she had been lied to by certain shareholders and officers of her employer. The executive said those shareholders and officers had misled her in an attempt to convince her to trade her phantom stock shares, for which she was currently entitled to cash, for restricted stock. More particularly, the executive claimed the directors and officers painted a very rosy picture about the company’s future fortunes, which they predicted would culminate in a lucrative initial public offering. The executive, after trading her phantom shares for restricted stock, was sorely disappointed when instead of hitting a big payday, her restricted stock became worthless when the company a few years later found itself in bankruptcy.

The executive argued that by failing to disclose to her important facts about the poor financial prospects of the company, various shareholders and officers committed “fraud by omission.” The court dismissed the executive’s complaint because it concluded that the shareholders and officers owed the executive no duty to speak. The court noted that in Illinois the requirements for fraud by omission are (1) concealment of a material fact, (2) with the intent to deceive, (3) where the plaintiff was unaware of the concealed fact and would have acted differently if she had known of it. Additionally, however – and this was the critical point of the analysis – the party omitting or concealing the material fact must have had the opportunity and duty to speak.

One circumstance in which a duty to speak will arise under Illinois law is where a “defendant’s acts contribute to the plaintiff’s misapprehension of a material fact and the defendant intentionally fails to correct [the] plaintiff’s misapprehension.” The court in Bors concluded that the defendants’ statements and alleged omissions did not create a duty to speak under this standard for two reasons. First, the defendants’ statements referred to future events, and statements that
relate to contingent events, expectations or probabilities, rather than to present facts, will not support a claim of fraud under Illinois law.

Second – and this is an important planning point for employers – the statements and omissions the executive complained of did not create a duty to speak because the restricted stock agreement specifically disclaimed any such duty. In particular, in her restricted stock agreement the executive acknowledged and agreed that neither the company nor its directors and officers had “any duty or obligation to disclose to [the executive] any material information regarding the business of [the company] or affecting the value of the stock,” including any plans to make a public offering of its stock. The executive, the court said, was therefore not justified in relying on oral statements made prior to her signing the restricted stock agreement and, as a consequence, even if the statements created misapprehension, the defendants had no duty to speak and therefore could not have committed fraud.

In contrast, in a 2003 decision from the same court, a plaintiff was able to bring a cognizable fraud claim because the plaintiff alleged a scheme to fraudulently misstate and conceal the net worth of his company. *Byczek v. Boelter Companies, Inc.*, 264 F.Supp.2d 720 (N.D. Ill. 2003). This was a cognizable claim because it involved misrepresentations and omissions of current financial conditions, not predictions of future performance.

The court also noted that in federal securities law cases, there is a duty to speak so as to render statements already made not misleading. Notably, in a decision from 2001, a federal trial court held that the former chairman of the board of a corporation stated a claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 where he alleged that the employer falsely denied the existence of an imminent merger when negotiating a severance agreement that provided for the sale of the chairman’s stock to the corporation. *Rizzo v. The MacManus Group, Inc.*, 158 F.Supp.2d 297 (S.D. N.Y. 2001).

**Lessons Learned**

There are at least two lessons to be learned from *Bors*. First, tell the truth. That will not only make your mother proud, but also minimize the number of reasons you might get sued. Although under Illinois state fraud standards, misrepresentations about future events may not create the same legal risk as misstatements of current facts, the risk of a federal securities fraud claim based on a misrepresentation about a company’s future plans or prospects would remain.

Second, and perhaps more practically, employers may wish to add to their equity compensation agreements the type of language which proved helpful in *Bors*. Recall that the directors and officers in *Bors* were not required to refute the executive’s claims that they failed to tell the whole truth because the restricted stock agreement expressly disclaimed any obligation to disclose to the executive material information. This type of provision was effective not only in *Bors*, but also in a decision by the Seventh Circuit Court of Appeals, which hears appeals from federal trial courts in the states of Illinois, Indiana, and Wisconsin. *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544 (7th Cir. 1996). In *Carr*, the Seventh Circuit stated that a fraud claim based on oral statements is barred when the claimant is also provided with a written statement contradicting the oral statements. Employers may therefore wish to include language in future equity compensation agreements disclaiming any duty or obligation to disclose to an executive any material information regarding the business of the company or affecting the value of the company’s stock.

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“Heads I win, tails you lose.”

Everyone loves a sure bet, and one clever employer (or, more likely, one employer’s clever attorney) appears to have found a way to ensure the enforceability of covenants not to compete in stock option agreements. Well, actually, the employer did not so much find a way to prevent an executive from competing as it found a way to recover options granted to an executive who does so. This creative employer’s ingenuity bore fruit when the federal Circuit Court of Appeals for the Fifth Circuit (which hears appeals from federal trial courts in the states of Louisiana, Mississippi, and Texas) permitted the employer to recover stock option compensation from a former executive by reason of the executive’s competitive activities, even though the agreement’s prohibition on competition was itself unenforceable. That is, the employer was able to recover option compensation it had conditioned on noncompetition even though the employer could not have obtained an injunction prohibiting the former executive from engaging in the listed competitive activities. The result was that the former executive had a legal right to compete, but had to repay almost $225,000 in stock option compensation he had received on the condition that he not compete. The Fifth Circuit reached this conclusion in *Olander v. Compass Bank*, 363 F.3d 560 (5th Cir. 2004).

All employers with multi-state operations should consider the lesson of the *Olander* decision. That is because a persistent worry for multi-state employers is the difficulty in enforcing uniform noncompete provisions, given the difference in standards the states apply in determining the validity of such prohibitions. Some states, like New York, make it easier to enforce noncompetes if all the employer wants is to avoid the need to pay severance, stock options, or other forms of compensation to a departed executive. In these states, even if an employer may not actually prevent a former executive from competing (for example, by getting an injunction prohibiting the former executive’s competitive activities), it might still be able to avoid paying the former executive certain types of compensation or be able to recover compensation already paid. The *Olander* decision offers a recipe for achieving this same result in other states.

In *Olander*, an executive was, under the terms of separate, annual stock option agreements, prohibited from engaging in certain competitive activities for two years after his termination of employment. The agreements barred the executive from soliciting existing customers, enticing employees to leave their jobs, and divulging trade secrets, customer lists, or other confidential information.
The special twist in these agreements was the inclusion of a provision the court termed “remarkable,” under which if the noncompete provisions were held by a court to be invalid or unenforceable for any reason in a lawsuit between the executive and the employer, the employer was entitled to have returned to it all stock held by the executive. If the executive had already sold stock obtained through an option exercise, the employer was instead entitled to receive from the executive the bargain element the executive enjoyed upon exercise, as well as any profit from the increase in value of the stock after exercise and before the executive sold the shares.

The executive in Olander had grown dissatisfied with his job and resigned to begin work with a direct competitor. Before leaving to do so the executive exercised his right to stock options under six different annual agreements and then immediately filed a declaratory judgment action in state court to have certain of the noncompetes declared unenforceable. The employer removed the lawsuit to federal court and asked for a preliminary injunction against the executive, which was denied.

The Fifth Circuit agreed with the federal trial court that the noncompete provisions were unenforceable under Texas law. That was because for a noncompete to be enforceable under Texas law the agreement must be “ancillary to or part of an otherwise enforceable agreement at the time the agreement is made.” This means, in part, that there must be some “consideration” the employer gives in exchange for the employee agreeing not to compete. The court found that the employer in fact gave no consideration in exchange for the noncompete. Although the executive was promised stock options, the court considered this promise “illusory,” and therefore incapable of constituting the consideration necessary to make a contract valid. The promise to pay option compensation was illusory because the executive was an at-will employee who could be fired at any time, and under the terms of the option agreement the executive’s options would terminate when employment terminated. This meant the employer could have, at any time, taken away what it was giving in exchange for the noncompete – the stock options – by terminating the executive.

Although the noncompete was unenforceable, the court did enforce the provisions requiring the executive to return the option compensation paid to him, since that compensation had been conditioned on the executive not competing. If the other federal circuit courts of appeal adopt the reasoning of the Fifth Circuit in Olander, employers can have confidence in their ability to condition the payment of compensation on an executive not competing, as opposed to being able to enjoin the executive from competing, the employer can impose a broader noncompete than would normally be enforceable.

Lessons

1. Employers should consider whether they want to condition stock options, or other executive compensation, on a former executive not competing.

2. If an employer wishes to do so, it should consider whether it is important to actually prohibit competition (and be able to obtain an injunction prohibiting an executive from competing) or whether the employer instead wants simply to avoid the payment of compensation (or recover compensation already paid) should an executive compete.
3. If an employer only wants the ability to condition the payment of compensation on an executive not competing, the employer should consider including in its option agreements, and possibly in other executive compensation programs, the type of “fail safe” provision included in Olander – that is, requiring an executive to repay compensation if the agreement’s noncompete is determined to be invalid or unenforceable.

4. Employers should consider whether to modify existing option (or other executive compensation) agreements to require the repayment of compensation where a noncompete is determined to be invalid or unenforceable. If an employer wishes to do so, it will need to carefully consider the existing agreements’ provisions concerning when and to what extent the agreements can be amended, and will need to comply with any constraints found in those provisions, such as any requirement that employees consent. An employer should probably also assume it will need to provide consideration to executives for the modification (that is, an employer may need to give executives something of value in exchange for their agreeing to repay compensation in the event the noncompete is determined to be invalid or unenforceable).

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NONQUALIFIED PLAN DISPUTES: 
THE IMPORTANCE OF PROCESS, PRECEDENT AND INTENT

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Disputes over nonqualified deferred compensation seem inevitable. After all, nonqualified plan documents are briefer, and sometimes more cryptic, than those for qualified retirement plans, and this can lay the groundwork for disagreement. Perhaps more telling, participants in nonqualified plans are, by their nature, executives who are more likely to have one-on-one discussions with key executives over the terms and effect of their nonqualified programs than are participants in broad-based qualified plans. This interaction – much of it oral and some of it occurring in informal conversations sprinkled over a period of years – can be fertile ground for misunderstanding.

A recent federal appeals court case, Scipio v. United BankShares, Inc., 2004 WL 2980756 (4th Cir. 2004), offers a good lesson to boards of directors, administrative committees, and others who interpret nonqualified plans on improving their odds at winning lawsuits over alleged plan ambiguities. The Scipio court, in resolving an ambiguity in favor of the plan administrator’s determination, placed heavy weight on the soundness of the process the administrator followed in reaching its conclusion. One may also read the decision as a triumph of employer intent and what the court may, at least sotto voce, have considered the common sense result, over what arguably would have been a fairer reading of the plan’s language.

Facts. The dispute in Scipio concerned how to determine compensation when calculating an executive’s nonqualified plan benefit. The plan was a defined benefit program. The promised benefit was 70 percent of the executive’s “final average earnings,” reduced by certain amounts. The executive argued that the plan should, for this purpose, count as earnings the executive’s taxable income upon the exercise of stock options. The company’s board of directors, which served as the plan administrator, instead found that stock option compensation should not be counted as earnings. The effect of including the executive’s stock option compensation would have been considerable, increasing the executive’s annual retirement benefit from roughly $74,000 to roughly $128,000.

Plan Language. At least to this reader, the plain terms of the plan seemed more supportive of the executive’s position. The earnings to be included were “the total earnings received from the [company] during a calendar year,” excluding specific bonuses not relevant to the court’s decision. The court found the quoted language to be ambiguous. It then reviewed the board’s decision as
plan administrator under an “abuse of discretion” standard, but accorded the board less deference than if the board had no conflict of interest (the conflict resulted from the company’s financial interest in limiting benefits under the unfunded plan).

**Court’s Analysis.** The factors important to the court in determining whether the board abused its discretion in determining that stock option compensation should not be counted as earnings were (a) whether the board considered adequate materials in making its decision, (b) whether it engaged in a reasoned and principled decision-making process, and (c) whether its ultimate decision was consistent with the plan provisions and the board’s earlier interpretations of the plan.

The court found that the board took pains to gather and consider information and material from a number of sources. Notably, the board hired a national employee benefits consulting firm to make the benefit calculation and obtained an opinion from a prominent law firm on the proper interpretation of the plan’s language. The court also noted approvingly that the board contacted the former CEO and chairman of the board of directors involved at the time the plan was drafted, as well as other employees, to gain an understanding of the intent behind the plan’s provisions. Those parties apparently advised that the plan was not intended to include as earnings gains realized from the exercise of stock options. The board was consistently advised that the intent of the plan was instead to provide retirement benefits for the key executives at roughly 70 percent of their typical annual salary. The court also noted that retirement benefits for other similarly situated executives had been computed without including their stock option gains. Finally, the court found support for the board’s interpretation in the Tax Code Section 415 rules applicable to qualified retirement plans (although this reader would not have found that argument persuasive). The court, in conclusion, found that the board’s determination that earnings for nonqualified plan purposes should exclude stock option gains was “the product of a reasoned and principled decisionmaking process based upon adequate materials and inquiry, and that the decision was consistent with the purposes and goals of the Plan, the Plan provisions, and its earlier interpretations of the Plan.”

The executive in Scipio was probably fighting an uphill battle in arguing for the inclusion of stock option gains. That is because counting those gains as earnings would, due to one item of nonrecurring compensation, have so dramatically changed the amount of the executive’s retirement benefit. It may have been that the court simply did not think it made sense to include large irregular items of compensation in the plan’s final average earnings calculation, when it believed the company’s intent was instead to replace a percentage of an executive’s “typical” compensation.

**Lessons.** The lessons of Scipio for employers are threefold. First, nonqualified plan documents should carefully describe the compensation to be counted when calculating benefits, just as would be the case under a qualified retirement plan. Second, nonqualified plans should include Firestone-type language, giving the appropriate committee (or other party) broad discretion to interpret the plan’s provisions. Third, the process followed by an administrative committee (or other party) in handling nonqualified plan claims may be as important as the reasonableness of the committee’s determination. This assumes the committee enjoys an abuse of discretion standard of review (due to the inclusion of proper Firestone-type language in the plan document). As a corollary, courts generally smile upon decisionmakers who consult independent professionals. These professionals may, in appropriate circumstances, include outside legal counsel, financial experts, actuaries, or consultants.

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A federal trial court recently considered whether a company acted properly in disclosing a CEO's agreement to repay certain compensation following the Company's conclusion that a large bonus paid to the CEO was unauthorized. 

Kamfar v. New World Restaurant Group, Inc., 347 F.Supp.2d 38 (S.D. N.Y. 2004). The case offers a roadmap on how to proceed when a company suspects unauthorized compensation may have been paid to a key executive.

The Company’s dispute with its CEO reached the courts when the CEO brought defamation and breach of contract claims based on the Company's disclosure of the executive's alleged misconduct. The Company had retained a law firm to thoroughly investigate whether $3.5 million in bonuses paid to the CEO and two other executives (the CFO and General Counsel) were authorized by the board. The portion received by the CEO was alleged to be approximately $1.6 million. The law firm reported to the board that the bonuses were not authorized. Although the board’s compensation committee had discussed the compensation at issue, the board had never acted in approving the compensation. The law firm advised the board that the Company's financial statements must, as a consequence, be restated.

The Company then entered into an agreement with the CEO to resign, repay his bonus of approximately $1.6 million, and receive severance pay in the amount of approximately $1.4 million. The agreement included mutual covenants not to make disparaging remarks, not to sue, and to keep the terms of the agreement confidential.

The Company issued a press release announcing the CEO's departure and the severance payments. The 10-K filed by the Company indicated that the bonuses were unauthorized, but did not disclose the parties to whom the bonuses were paid. A company representative, however, told a reporter that the CEO was one of those who had received the bonuses at issue. The reporter's newspaper then published this information. Although the law firm had advised the board that the securities laws required disclosure of the circumstances underlying the restatement and the $1.4 million payment to the CEO, it did not advise that the identity of the recipients of the bonuses must be disclosed.

**Defamation.** The court made several rulings. First, the court held that, under New York law, although the matter involved “private figure” defamation, the CEO was suing on a statement that was “arguably within the sphere of public concern” (which the CEO conceded). In this circumstance, a successful plaintiff
must show that the defendant "acted in a grossly irresponsible manner, without due consideration for the standards of information gathering and dissemination ordinarily followed by responsible parties." The CEO failed to show that the Company acted with gross irresponsibility in publicly characterizing the bonuses as unauthorized. The court cited a number of New York cases where companies’ reliance on thorough, responsible internal investigations of potential employee misconduct defeated defamation claims when the results of the investigation were published.

Confidentiality Agreement. Second, the court concluded that the Company did not breach the confidentiality provisions of its agreement with the CEO because whether the bonus was authorized was not a term of the agreement. Instead, the agreement prohibited disclosure of the terms of the agreement and the agreement did not itself describe the bonus as unauthorized.

Nondisparagement Claim. Third, the court refused to grant summary judgment for the Company on the CEO’s claim that the Company breached the agreement’s nondisparagement provision. Although the agreement prohibited disparagement of the parties by one another, it did allow the Company to make disclosure to the extent the Company, in good faith, believed disclosure to be necessary or desirable to protect the Company’s interests. The court held that it was unclear whether the disclosure that the bonuses were unauthorized was the product of good faith reliance on the advice of counsel.

Covenant Not to Sue. Finally, concerning the CEO’s covenant not to sue, the court found that there was no exception permitting the CEO to bring a tort claim or a declaration (which the CEO requested of the court) that the bonuses were authorized. Nevertheless, the court refused to award the Company attorneys’ fees as a remedy for the CEO’s breach of the covenant not to sue because the court said absent a clear intention to the contrary set forth in an agreement, parties can only use a covenant not to sue as a defense or to establish liability where suit is brought in obvious breach of the contract or otherwise in bad faith. The court found that the CEO’s suit was not in obvious breach of the contract nor in bad faith. The covenant not to sue did not, incidentally, interfere with the CEO’s ability to enforce the terms of the agreement, so the CEO’s claim for breach of the agreement’s nondisparagement provision could continue.

Lessons. The Kamfar case underscores the need for companies to carefully consider how they go about investigating, and ultimately disclosing, executive misconduct. The Company in Kamfar did a lot of things right. It was helped by having undertaken a thorough internal investigation of the charge of executive misconduct, and by employing a carefully drafted confidentiality agreement. In particular, the provision in the Company’s agreement with the CEO permitting disclosure to the extent the Company, in good faith, believed disclosure to be necessary or desirable to protect the Company’s interests was important. Because the court determined that additional facts were necessary to determine whether the disclosure that the CEO’s bonus was unauthorized was the product of good faith reliance on the advice of legal counsel, the court did not, however, rule on the merits of the CEO’s claim that the Company breached the agreement’s nondisparagement provision. The lesson here may be that even after engaging in a careful investigation, including the use of outside counsel, a company will best be protected against nondisparagement claims by disclosing only those facts it is advised by legal counsel must be disclosed. . . ."

The information in this newsletter is of a general nature only and does not constitute legal advice. Consult your attorney for advice appropriate to your circumstances.

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ARBITRATION OF EXECUTIVE DISPUTES: 
BENEFIT ELIGIBILITY 

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A recent court decision highlights the potentially broad application of arbitration provisions in executive employment agreements. In Maroney v. Triple "R" Steel, Inc., a federal trial court concluded that an executive was required to arbitrate his claim for COBRA coverage under his employment agreement's general arbitration clause because the employment agreement obligated the company to provide medical coverage.

The ruling is a bit enigmatic in its explication of why the executive failed to successfully secure COBRA coverage. The court said the company, while the executive was employed, "obtained a Blue Cross Blue Shield medical insurance plan . . . for [the executive]." That plan included a section on COBRA rights. Although the company failed to inform the executive of his COBRA rights following termination of employment, the executive sent the company a letter electing COBRA coverage and included a check for his initial premium. The company endorsed the executive's check and forwarded it to the insurer. The puzzling part is that the insurer returned the check, indicating that it would only accept payment from the company and not from the terminated employee. On two subsequent occasions, the executive personally delivered premium checks to the company. The company did not, however, properly submit those checks or its own checks to the insurer, and the executive eventually lost insurance coverage for failure to pay premiums.

The executive then filed suit. The company asserted that the court lacked jurisdiction because the claim was subject to arbitration under the terms of the executive's employment agreement. The court agreed. After noting that Illinois, like most states and the federal government, favors the enforcement of arbitration clauses, the court concluded that the claim at least arguably arose out of or was connected with the employment agreement and therefore was within the scope of the arbitration clause.

The decision raises a couple of questions for employers. The first, of course, is whether an employer wants to arbitrate employment disputes. Some feel that the cost of doing so is less than the cost of defending a lawsuit. Others believe arbitration is just "litigation without rules," and the cost savings are uncertain. Important, of course, is whether an employer thinks the actual results of arbitration will tend to be more favorable, leaving aside the costs of the process.
The second question for employers favoring arbitration concerns the scope of the claims to be arbitrated. Even companies generally favoring arbitration may prefer that disputes relating to benefits (as opposed to eligibility) under broad-based employee benefit programs be handled under those plans’ normal claims and appeals procedures. In this way, all participants’ claims can be handled in the same fashion under uniform, well-practiced procedures. One approach might be to compel the arbitration of claims of eligibility for coverage under plans subject to ERISA, without requiring arbitration of benefit claims under those programs (instead subjecting benefit claims to the plans’ normal claims and appeals procedures, followed by the opportunity to file a lawsuit). It may be particularly appropriate for benefit claims under insured plans to be handled through the normal plan appeals channels since an employer could otherwise find itself obligated under an arbitration award to pay benefits that the insurer refuses to provide. The result would be an unexpected self-insured obligation.

Employers wishing to except benefit determinations from their arbitration provisions should do so clearly. That is the lesson from court decisions addressing whether arbitration provisions in collective bargaining agreements apply to individual benefit determinations. In those cases, the results have been fact specific, typically turning on whether the bargaining agreement incorporates or references a summary plan description or plan document which itself sets forth a claims and appeals process. If a bargaining agreement does incorporate or reference an SPD or plan document, arbitration will typically be excused. Otherwise, arbitration of benefit disputes may well be required.

With respect to benefit claims under plans not subject to ERISA – particularly equity-based incentive programs – companies that generally favor arbitration will likely want to require the arbitration of eligibility and benefit disputes alike. The argument for subjecting executives to the same benefit determination process as applies to other employees would, of course, not apply so forcefully to these more narrowly tailored programs.

**Lessons.** Companies should consider whether their general philosophy on the arbitration of disputes should apply as well to executive employment agreements. If so, those agreements should clearly specify the scope of an executive’s obligation to arbitrate compensation and benefit disputes, including whether both eligibility and benefit determinations are to be subject to mandatory arbitration. This is particularly important where the compensation or benefit at issue is described not only in the employment agreement, but also in further detail in a separate plan document or other writing.

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CHANGING STOCK PLAN ADMINISTRATORS: HANDLING THE TRANSITION

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A recent federal appeals court decision serves as a reminder of the confusion which can result when changing stock plan administrators, and how to avoid liability as a result of that process. The case, Sheils v. Pfizer, Inc., 2005 WL 2404536 (3d. Cir. 2005), concerned a former employee's claim that he was entitled to additional time to exercise stock options upon termination of his employment because he did not receive adequate information about the new process for exercising options.

In Sheils, the court applied California law, presumably due to a choice of law provision in the relevant stock option agreements, in deciding not to extend the option agreements’ normal deadline for exercising options. Although courts frequently enforce time limitations for exercise despite employees’ claims that they were promised a different deadline would apply, this decision is interesting because of the context in which it arose. The confusion occurred by reason of a change from in-house administration of the option plan to an outside stock plan administrator, Merrill Lynch.

**Stock Option Agreements.** The employee’s stock option agreements explicitly set forth manner and time requirements for the exercise of options. The agreements required that all employees exercise their options by giving written notice to the company, and required that a terminated employee exercise his or her options within three months after the date on which his or her employment terminated.

**Switch in Plan Administrator.** Although the stock option agreements required that employees exercise their options in writing, they did not indicate more specifically how employees were to do so. In particular, they did not indicate what information employees should include in their exercise notice nor to whom employees should give their notice. At the time the plaintiff terminated employment, the appropriate process was to give a notice of exercise to the stock plan administrator, who was a particular individual at the company. This process changed, however, after the employee terminated employment and before the deadline for exercising his options. Under the modified process, employees were required to open an account with Merrill Lynch and exercise their options through that institution instead of through the individual who had been serving as in-house plan administrator.
The employee received a mailing from the company a few weeks before his employment was terminated, advising him as follows:

Next week you will receive a Pfizer Stock Option Package in the mail. This kit will prepare you for the July 1, 2002 transition to the Merrill Lynch system. This kit will include important information about the new service, what you need to know to open an account and exercise your options and an invitation to . . . upcoming information sessions . . .

The company claimed it sent the kit referred to in the mailing to all past and current employees and that it did so during the month in which the employee terminated. The employee said he never received the kit and therefore never saw instructions for exercising his options under the new system.

**Helpful Factors.** The company had done several things that helped it win the lawsuit. The first was sending to the employee the preliminary mailing announcing the switch to Merrill Lynch. Second, the company provided the employee with separation documents upon his termination of employment reminding him that his stock options were subject to the terms and conditions of the stock option agreements. The separation documents also included a Merrill Lynch phone number that terminated employees could call if they had questions regarding their stock options. That phone number was the same number provided to employees in the kit.

**Employee’s Complaints.** The person who had been serving as plan administrator, and who continued to serve as administrator on the date the employee terminated employment, usually sent terminated employees a certified letter informing them of how many options they had, how to go about exercising their options, and the deadline for doing so. The employee claimed he did not receive such a certified letter. The employee also claimed he called the individual who served as stock plan administrator on the day he was terminated, asking for information about his stock options and how he could exercise them, but the administrator did not respond to his voicemail message.

The employee asserted that he called Merrill Lynch within the timeframe for exercising his options (using the number that was listed in the separation documents), and asked for information about his outstanding options. He said the person to whom he spoke told him Merrill Lynch could not help him because he did not have an account at Merrill Lynch. The employee claimed that he later called the in-house plan administrator again, before the switch to Merrill Lynch had become effective, but that she did not respond. The employee said he also did not receive an e-mail that the outgoing administrator sent on her last day of employment, reminding employees that she was leaving the company, and that they should contact Merrill Lynch to exercise their options.

On the day after his options expired, the employee received a status report from Merrill Lynch informing him that his options had expired on the previous day. He said he immediately called the number on the report and left a message. The next day, he called a representative of the company, who confirmed that the employee’s options had expired and would not be reinstated.

**Court’s Conclusion.** The court concluded that the employee did not exercise his options in the limited period of time set forth in the option agreement, and that this timeframe must be strictly enforced. The employee argued that the company had prevented him from exercising his options by failing to inform him how to exercise once Merrill Lynch replaced the in-house stock plan administrator. In particular, the employee complained that the in-house
"The company did well by providing multiple forms of communication concerning the change in stock plan administrator (and therefore the change in the process for exercising options)."

The court rejected the employee’s argument that he was entitled to be excused from the time limitations under the stock option agreements, explaining that under California law no such relief is available where the failure to exercise results from the employee’s own neglect or inadvertence and was not contributed to by the employer. In this regard, it was undoubtedly helpful that the employee admitted receiving an initial mailing indicating that the switch to Merrill Lynch would occur (and indicating the date on which it would occur), and that the employee’s separation documents included a contact telephone number at Merrill Lynch. The company might have strengthened its position further if it had a clear protocol with Merrill Lynch requiring that Merrill Lynch provide information concerning exercise even prior to an employee establishing the necessary account for implementing a decision to exercise, and if Merrill Lynch had followed that protocol. (It should be noted that all of the employee’s allegations were taken by the court as true for the purpose of its ruling, so it is possible there was such a protocol in place.)

The court also rejected the employee’s argument that improper notice of the exercise process was given because the stock option agreements provided that any notices or other communications “permitted or required” under the agreements had to be writing and had to be served personally or sent by registered or certified mail. Among other reasons, the court rejected this argument because the materials concerning Merrill Lynch were not required to be provided, and they were permitted to be provided to the employee only in the sense that the stock option agreements did not explicitly forbid the company from providing the materials. The court concluded that when referring to “permitted” notices or communications the agreements surely were not referring to every communication not explicitly forbidden by those agreements, but must instead be referring only to communications specifically mentioned in the agreements as optional (that is, communications affirmatively permitted under the agreements).

**Lessons.** The company did well by providing multiple forms of communication concerning the change in stock plan administrator (and therefore the change in the process for exercising options). It sent an initial mailing to employees, informing them that there would be a subsequent, more detailed, mailing to follow. In addition, the company provided an appropriate contact telephone number for the new stock plan administrator in the employee’s separation documents. The company might have improved its position further if it had in place a clear protocol with the new stock plan administrator requiring that Merrill Lynch provide information concerning exercise even prior to an employee establishing the necessary account for implementing a decision to exercise.

Companies may wish to minimize ambiguity in their option agreements concerning any requirement that notices or communications “permitted” under the agreements be provided in a particular form or fashion by deleting mention of “permitted” notices or communications if none are in fact contemplated. In that event, any process described in the agreement for providing notice or other communications would apply only where a communication is required.

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TERMINATION WITHOUT CAUSE?:
WRITTEN NOTICE REQUIREMENT SAVES EMPLOYER 
SEVERANCE PAY 

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When an executive resigns in anticipation of being terminated without cause, is that a voluntary termination or a termination without cause? The answer in a recent court case was that the executive’s resignation was just that, a resignation. It was not, under the terms of the executive’s employment agreement, a termination by the employer because the employer had not provided the executive with the written notice required under the agreement for a termination without cause. As a result, the executive, by resigning before being involuntarily terminated, lost his entitlement to severance benefits. Barnes v. Bradley County Memorial Hospital, 2006 WL 20551 (6th Cir. 2006)(unpublished).

Circumstances of the Termination. The lawsuit was brought by the administrator of a hospital following the hospital's refusal to pay severance amounts that were due under the administrator's employment agreement in the event of a termination “without cause.” The administrator had, according to his account, been embattled prior to his resignation. He had come under considerable criticism from the hospital’s physicians and, it appeared, the hospital’s board of trustees was actively considering terminating his employment. In particular, a special meeting of the hospital’s medical staff had been called to discuss the administrator’s leadership, after which the chief of the medical staff had talked to each member of the hospital’s board to advise them of the medical staff’s “feeling [of] no-confidence in the administration.” About a week later, the board met to consider and approve the hospital’s liability insurance, but after resolving that question and after the administrator left the meeting, the board continued to meet for another 45 minutes or so. According to the administrator, this was the only time the board had met without the administrator in attendance. Three days later, the chairman of the board contacted the administrator's assistant to schedule a meeting with the administrator. This was unusual because typically the chairman would call the administrator directly to schedule a meeting, rather than working through the administrator’s assistant.

From these circumstances, the administrator concluded that the board was going to ask for his resignation. The administrator, therefore, drafted a letter of resignation in case it was requested at his meeting with the chairman, which was to be held the next day.

The administrator did, in fact, meet with the chairman of the board the next day, as well as with the secretary of the board. According to the administrator’s description of the meeting, which the court took to be accurate for purposes of ruling on the employer’s motion for summary judgment, the chairman and secretary of the board entered the administrator’s office without any of their customary warmth or familiarity. Further,
[The Chairman] made various statements such as: “this is the most difficult thing I’ve ever had to do”; “I’ve never had to do anything like this before”; and “[t]his is so onerous to me that I haven’t been able to sleep for three nights.” [The Chairman] also told [the administrator] that he had gone to the Board rather than doing what I have to do” [The Chairman] said the Board attorney “told me I could not resign, but I had to carry out the desires of the Board.” [The Chairman] then said, “[o]ne reason why this is so hard is because I like you so much.”

The administrator said he believed these statements had only one logical meaning, and he therefore produced his letter of resignation. The chairman and secretary of the board accepted the administrator’s letter without objection or question, and without any indication of surprise. The chairman told the administrator that “this” was not the unanimous decision of the board, but that it was a “majority decision.”

**Claim for Severance Pay.** The administrator argued that he was entitled to severance benefits payable under his employment agreement upon termination without cause. There is no indication in the court’s opinion that the hospital argued that had it terminated the administrator that termination would have been for cause. Instead, the hospital argued that it had not, in fact, terminated the administrator at all. The administrator had simply resigned.

The hospital prevailed because the employment agreement under which severance benefits were to be paid provided that employment could be terminated by the hospital without cause by giving to the employee notice of termination without cause. The agreement required that the termination date be set forth in the notice, and that the termination date be at least 30 days from the date the notice was received by the employee. Importantly, the agreement provided that the notice must be in writing.

The court concluded that because there was no written notice of termination from the board, the administrator could not have been terminated without cause within the meaning of the employment agreement. As a result, the administrator was not entitled to severance benefits.

**Lesson.** The court, in its opinion, assumed that the facts asserted by the administrator were true. It is, of course, possible that the facts recited in the court’s opinion could not be proved. Nevertheless, when reading the court’s opinion, one is inclined to conclude that the hospital’s board had decided to terminate the administrator (and, presumably, without cause). The employer prevailed, though, because the employment agreement included a written notice requirement for termination without cause. The case, therefore, teaches the value of including in employment and compensation agreements a requirement that an employer give an executive written notice of any termination of a type entitled the executive to severance or other special compensation. The inclusion of such a requirement should reduce the chance an employer’s actions will be misunderstood as a termination entitling an executive to compensation when that was not, in fact, the intention.

Perhaps notably, the court did not designate the decision for official publication. It is possible other courts faced with similar facts would ignore the agreement’s written notification requirement, instead concluding that the executive was terminated without cause under a constructive discharge theory. The inclusion of a written notice requirement would, nonetheless, seem to offer at least some protection for employers concerned about disputes over whether they have taken action in connection with an executive’s termination that entitles the executive to severance or other special compensation.

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CONFlicts concerning the period for exercising stock options are very common, particularly following a contentious termination of employment. A recent case suggests a couple of tips for helping employers prevail in those disputes. The case is Donaldson v. Digital General System, 168 S.W.3d 909 (Tex. App. 2005), a state court decision from the Court of Appeals of Texas.

In Donaldson, the former president of a company brought suit against his former employer for refusing to honor the president’s request to exercise stock options after he left the company. The president argued that he had one year following termination of employment to exercise, while the company maintained that he had only 30 days to do so. The company prevailed in the litigation, even though the president’s employment agreement seemed to give the president a full year to exercise. In particular, under the employment agreement the term of the option was ten years, "subject to earlier expiration one year following the termination of [the president’s] Employment or other service with the Company."

The company prevailed because although the provision of the employment agreement dealing with stock options said the president would have one year to exercise following termination of employment, it went on to provide that the grant was subject to “the other terms and conditions set forth in one of the [company’s] Stock Option Plans and in the company’s standard form of stock option agreement . . . .” The referenced option agreement provided for only a 30 day exercise period following termination of employment. In addition, both the employment agreement and the option agreement were subject to the company’s stock option plan, which also provided for a 30 day post-termination period for exercise (unless a longer period was determined by the company’s board of directors at the time of grant).

In determining which of the conflicting provisions applied – the one-year exercise period in the body of the employment agreement, or the 30-day period in the option agreement and plan document – the appeals court concluded that the employment contract was ambiguous and deferred to the trial court’s finding that the parties intended a 30-day exercise period. The trial court had accepted testimony from the parties concerning their discussions and negotiations about the employment agreement. The testimony of the chairman of the board was equivocal, but the court noted that the president was well versed in the details of the plan, had received and exercised prior grants, and acknowledged that the board was authorized to issue the options only under the approved plan, which
set forth the 30-day post-termination exercise period. The court was not persuaded by the president's argument that the employment agreement unambiguously provided a one-year period for exercise. The president had argued that when the employment agreement referred to "other" terms and conditions from the option agreement and option plan, these terms did not include the time limit for exercise since that term had been explicitly set forth in the employment agreement (as one year) and, therefore, could not be an "other" term.

Interestingly, the court also concluded that even if the president had a right to exercise his options for a full year following termination, he had failed to timely exercise because he had not made written demand for exercise within that one year period. Instead of making written demand, the president had called the company's employee in charge of administering stock options about three months following his termination to inquire about exercising his options. The employee testified that she told the president her records showed he had no active stock options. She then referred the matter to the company's chief financial officer, who spoke to the president about the 30-day time limitation.

This failure to make written demand was important because the option agreement provided that the options were "exercisable by written notice," and set forth the details required to be in such a notice. The president argued that when the employee responsible for the stock option program told him he had no active options on her books, this constituted a breach of the company's obligation to honor his options, and thereby excused him from any further obligation to submit notice. The court rejected this argument, concluding that the requirement to give written notice for exercise was not excused by the company's employees telling the president he had no active options available for exercise.

Lessons. The Donaldson case teaches two lessons. The first is that the common practice of including in employment agreements a statement that any stock option awards will be subject to the terms of the company's stock option plan and the option award agreement, and that the terms of the plan and award will prevail in the event of conflict with the employment agreement, is a good one.

The second lesson is that there can be value in including in a stock option plan and award agreement a requirement that options be exercised in writing and, perhaps, in including a requirement that exercise be made by use of a particular form approved by the board's compensation committee (or other committee administering the plan). Requiring the use of a particular form to exercise, or requiring that particular information be included in any written notice to exercise, may reduce uncertainty as to when an executive has properly and timely exercised.

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FORFEITURE OF NONQUALIFIED BENEFITS FOR VIOLATING NONCOMPETE: BURDEN OF PROOF

by
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A federal trial court held that it was unreasonable to deny nonqualified deferred compensation benefits for violation of a noncompete where the executive had the burden of proving that he or she had not been in competition with the employer. Violette v. Ajilon Finance, 2005 WL 2416986, 32 EBC 1414 (D. N.J. 2005).

Notably, the court reviewed the plan committee’s denial of benefits on the basis of whether the committee’s decision was made in good faith. This is normally an easy standard for a committee to satisfy. The court explained that as a “top-hat” plan, the normal determination of the appropriate standard of review for a plan subject to ERISA does not apply. The court instead treated the top-hat plan as a unilateral contract and applied the federal common law of contracts to determine how carefully it should review the committee’s decision. In this case, the plan document granted the committee the power to make conclusive decisions concerning the plan’s terms. The court accepted this, but noted that in making its determinations the committee is subject to an implied duty of good faith and fair dealing.

The court held that the committee violated its duty of good faith by acting in bad faith in deciding the participant violated the plan’s noncompete requirements. That was because the committee enforced a plan provision placing on the participant the burden of proving that he was not violating the noncompete. The court said this effectively required that the participant prove a negative, which the court held to constitute an unreasonable requirement. The court also found that the committee gave the participant inadequate guidance on how to satisfy his burden of proof. The participant had, in fact, given the committee financial information and made representations about why his business did not violate the provisions of the noncompete, but was not told what additional information he should provide to satisfy his burden of proof.

**Lesson.** The lesson of the decision is that although an employer’s nonqualified deferred compensation arrangements can and should provide a plan committee with broad discretion to determine whether and when benefits are due, and although a plan may provide for the forfeiture of benefits upon violation of a noncompete requirement, a plan should not place on participants the burden of proving that they have not competed with the employer. Instead, the plan should give the committee broad power to determine whether a participant is entitled to benefits, and to require the participant to provide any information requested by the committee to help it in making its determination.
IMPLIED RIGHT TO REDUCE DEFERRED COMPENSATION FOR BAD BEHAVIOR

by

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A federal trial court has made an interesting decision concerning the obligation of a company to pay deferred compensation to an executive who is terminated for bad behavior. The case is Foley v. American Electric Power, 2006 WL 571886, 37 EBC 1663 (S.D. Ohio 2006).

The court considered a claim by an executive of an energy company who was terminated after he admitted to engaging in false reporting of energy trading transactions to industry publications. The executive had participated in a phantom equity plan and, in that connection, chosen to defer 90 percent of his phantom equity compensation into an incentive compensation deferral plan. After his termination, the executive made a claim for payment of more than $2 million accrued under the deferral plan. The company denied the executive’s claim, asserting that had it been made aware earlier of the executive’s misconduct it would have terminated him then, and this would have foreclosed any interest he had in the phantom equity plan that was the basis for his deferrals.

The court did not focus on the company’s assertion that it would not have paid the executive the phantom equity compensation had it known earlier of the executive’s misbehavior. Instead, it considered the company’s ability under the terms of the deferred compensation plan to setoff against amounts owed the executive any portion accrued during the executive’s period of “disloyalty” to the company. The court concluded that the company had such a right of setoff. In reaching this conclusion, the court focused intently on the deferred compensation plan’s lack of a nonforfeiture provision.

Because the arrangement was a top hat plan exempt from ERISA’s nonforfeiture and nonalienation provisions, the court turned to contract principles (which it applied as a matter of federal common law) to determine the rights of the parties. Under the federal common law of contracts, the court explained, contracting parties may expressly preclude setoff between them by agreement. However, a waiver of an employer’s (or other party’s) right of setoff “cannot be inferred from equivocal language nor deduced from ambiguous expressions.” Instead, contractual language must be clear and explicit in explaining the intent of the parties to preclude setoff, if setoff is to be prohibited. The court quoted another court for the conclusion that “few cases have found contractual language to be sufficiently specific and precise to constitute a waiver of setoff.” The court held that in the absence of an express prohibition of setoff, the federal common law of contracts authorizes the offsetting of one party’s contractual obligation to the other.
The executive had argued that as a matter of contract law he was entitled to the disputed monies because the terms of the plan unambiguously provided for the payment of benefits and the plan itself included no forfeiture provision permitting the denial of benefits. In other words, the executive argued, if one simply took the language of the plan at face value, the executive was entitled to his $2 million. This argument has a certain straightforward appeal, but apparently not for the court. The court said, in effect, that if a top hat plan does not protect a participant by expressly prohibiting forfeiture (through a nonforfeiture provision), the employer has an implied right to refuse to pay benefits to the extent the amounts accrued during a period of “disloyalty” to the employer. The court framed this as a right to “setoff,” although it seems tantamount to a simple forfeiture since (as explained below) the amount of the benefit reduction does not correspond to the employer’s damages, but instead to the period of disloyalty.

The court, in reaching its decision, distinguished a federal appeals court decision, Fields v. Thompson Printing Co., 363 F.3d 259 (3d. Cir. 2004). In Fields, the appeals court held that an executive who had misbehaved was nevertheless entitled to post-termination benefits and compensation because his employment contract included an express nonforfeiture clause and that clause did not include any exception relating to the executive’s conduct. The Foley court said the Fields decision involved a different circumstance than was before it because in Fields the employment contract did include a nonforfeiture provision. In contrast, in Foley the deferred compensation plan did not expressly preclude forfeiture. The court said the Fields decision simply means that where there is a nonforfeiture provision a court will not imply a conduct-related exception to the obligation to pay benefits.

The Foley court also said that the employer’s right to setoff amounts that accrued during periods of disloyalty did not depend on the executive having received any improper personal benefit from that disloyalty. The court seemed to say that the amount of setoff would be limited to the benefits accrued during the period of disloyalty, rather than being measured by any larger amount of damages the employer may have suffered (although the employer might, presumably, have a separate right of action to recover the remaining portion of its damages).

The court said it did not have enough information to reach a final conclusion as to the employer’s right of setoff, because further factual development was necessary to determine whether the executive was in fact disloyal to the company. In particular, the court raised some question about whether the executive should have been aware of the legal and practical implications of his false reporting. (The court was ruling only on summary judgment motions, so the facts had not been fully developed.)

The court looked to state law in determining what constitutes disloyalty permitting setoff. In this case it looked to Ohio law, which has adopted the “faithless servant doctrine” enunciated by the Kansas Supreme Court. That doctrine provides as follows:

[D]ishonesty and disloyalty on the part of an employee which permeates his service to his employer will deprive him of his entire agreed compensation, due to the failure of such an employee to give the stipulated consideration for the agreed compensation. Further, as public policy mandates, an employee cannot be compensated for his own deceit or wrongdoing. However, an employee’s compensation will be denied only during his period of faithlessness.
The court, in indicating that the facts needed to be further developed, not only said that it wished to determine whether the executive was aware of the legal and practical implications of his false reporting, but also that it needed to consider whether the executive’s repeated misreporting of trades to outside publications and his attempts to conceal his own and his subordinates’ misconduct met the requirement of the faithless servant doctrine that the dishonesty and disloyalty “permeate” the executive’s service to the employer.

**Lessons.** Those who draft plan documents for broad-based programs, such as qualified retirement plans, are used to routinely including anti-alienation and nonforfeiture provisions. They do so, presumably, to satisfy the vesting and anti-alienation requirements of ERISA and the Tax Code’s qualified retirement plan rules. The Foley decision suggests that it may be best for employers not to unthinkingly include such provisions in their nonqualified deferred compensation programs, instead carefully considering the consequences of including such provisions. Anti-alienation provisions may be helpful in protecting an executive from the claims of creditors, and helping an employer avoid the nuisance of unrelated third parties making claims for benefits. Nonforfeiture provisions, though, are a different matter. Although the inclusion of a nonforfeiture provision may be a matter for negotiation with an executive, it may better protect a company’s interests in the event of executive misbehavior not to include such a provision.  

"Although the inclusion of a nonforfeiture provision may be a matter for negotiation with an executive, it may better protect a company’s interests in the event of executive misbehavior not to include such a provision."
A federal appeals court recently rejected a former employee’s complaints about her employer’s decision to suspend her right to exercise stock options when the company found it necessary to retract its financial statements. In In re Cendant Corp. Securities Litigation, the federal appeals court for the Third Circuit, in an unpublished decision, addressed both (a) the company’s decision to impose a blackout on the exercise of options, and (b) its compensation committee’s decision to later extend the period for exercise to compensate for the blackout.

The lawsuit was brought by an employee who resigned and, as a result, faced a four month deadline for exercising her options. Prior to the former employee making a request to exercise, the company learned of problems with its accounting practices and retracted its financial statements from the SEC. The company concluded that federal law did not allow it to issue additional stock until it had filed new financials. For that reason, the company imposed a temporary blackout on the exercise of employee stock options and informed the former employee that it would not release shares of stock in response to her exercise request. Once the blackout was lifted, the former employee was allowed an additional number of days to exercise her options equal to the number of days she lost during the blackout period. Although the former employee took advantage of this extended opportunity to exercise, she earned substantially less than she would have had she been able to acquire and sell her stock during the blackout period.

The former employee argued that the company had no right to bar her from exercising her options during the blackout period. She noted that although the terms of the option plan allowed the company to postpone issuing certificates as necessary or desirable to comply with the requirements of securities laws, and allowed the compensation committee to impose restrictions on the resale of shares, it did not explicitly authorize the company or committee to impose a prohibition on exercise. The court rather easily rejected this argument that the company breached its contract, saying that what the company did was “practically indistinguishable” from what it was clearly authorized to do – that is, to refuse to issue certificates upon exercise and to restrict the resale of shares. In addition, the court observed that the company’s refusal to allow the former employee to exercise was better for the former employee than allowing her to exercise, take her money, but not give her the shares until later. Notably, the court seemed to suggest that even if there had been no plan provision authorizing the withholding of shares, the court would have implied such a right. In that regard, the court said “[i]t is axiomatic that a court may refuse to enforce a contract that violates public policy.” Presumably, requiring a company to
violate federal securities laws in order to honor the terms of an option agreement would violate public policy.

For reasons that are not apparent from the court’s decision, the former employee also argued that the company had no right to extend her period for exercise following the blackout period. The court rejected this argument for a variety of reasons. For one thing, the court said, the extension was a proper exercise of the compensation committee’s power under the plan “to make all other determinations necessary or advisable for administering the Plan.” The court also rejected the former employee’s claim because even were there a breach of contract, the former employee would have suffered no damage. That is because even if the company had permitted the former employee to exercise during the blackout period, it would have prevented her from selling the stock she acquired for the balance of the blackout period. The former employee therefore could not have captured the current value of the shares as of the date she wanted to exercise. And, of course, had the company refused to extend the exercise period, the former employee would certainly have been in no better position than under the course of action taken by the company, which provided her with an extended period of time in which to exercise.

Lessons. The Cendant decision is a reminder of the value of including in a stock option plan and any resulting option awards an express provision permitting the plan’s administrative committee (a) to suspend the right to exercise during any blackout period that is necessary or desirable to comply with requirements of the securities laws (and, perhaps, other laws), and (b) to extend the period for exercise by an equal period of time. Although the result may be the same where, as in Cendant, a plan simply authorizes the company to postpone issuing certificates without expressly prohibiting exercise, the inclusion of an express prohibition on exercise may head off litigation.

Where a plan fails to include an express provision prohibiting exercise, the Third Circuit’s rationale in Cendant – that a court may refuse to enforce the terms of an option agreement (or other contract) that would otherwise require the company to violate securities or other federal laws – may provide an implied right to prohibit exercise during a blackout period required under the securities laws (or other federal, and perhaps state, laws). Similarly, where a plan, such as that in Cendant, fails to provide for a post-blackout extension of the exercise period, the court’s argument in Cendant that such an extension was the proper exercise of the plan administrative committee’s power “to make all other determinations necessary or advisable for administering the Plan” may prove helpful, although one should note that the court’s decision was unpublished and, therefore, not precedential.

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EXECUTIVE COMPENSATION AND BANKRUPTCY:
RETENTION PAYMENT RULES

by

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Federal trial courts have begun interpreting changes made to the Bankruptcy Code in 2005 that were designed to restrict retention pay and severance benefits. Several recent cases have addressed what constitutes a retention payment, so as to be subject to the special and strict rules on the addition of that type of compensation during bankruptcy. Two of these recent decisions have involved Dana Corporation. In re Dana Corporation, 351 BR 96 (Bankr. S.D.N.Y. 2006) and In re Dana Corporation, 2006 WL 3479406 (Bankr. S.D.N.Y. 2006). A third case is In re Global Home Products, LLC, 2007 WL 689747 (Bankr. D.Del. 2007).

A primary issue in each case was whether a compensation program constituted a Key Employee Retention Plan ("KERP"), also known as a "pay to stay" compensation plan, or was instead a program intended to create incentives for management and key employees, that is, a "pay for value" compensation plan. If a plan is a KERP, it is subject to special restrictions set forth in Section 503(c)(1) of the Bankruptcy Code. If, instead, a plan is intended to provide incentive compensation to management employees, a court is to apply a more liberal business judgment review under Bankruptcy Code Section 363 in determining whether the debtor may adopt the program.

Historically, compensation issues for debtor companies have generally been governed by business judgment standards. In 2005, however, Congress modified the Bankruptcy Code through the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCA"). That Act addressed, in part, Congressional concern over perceived abuses concerning retention programs. In particular, Congress hoped to end the practice of paying substantial bonuses to executives simply by reason of their remaining with the debtor company through the bankruptcy process. Under the revised Bankruptcy Code provision, a bankruptcy court is not to authorize payments to an "insider" for the purpose of inducing the insider to remain in the debtor's employ, unless the court determines that (a) the payment is essential to the retention of the person because he or she has a bona fide job offer from another business at the same or a greater rate of compensation, (b) the services provided by the individual are essential to the survival of the business, and (c) certain limitations are applied to the amount of the compensation. As to those limitations, the amount of the retention payment to an insider must not be greater than 10 times the amount of the average compensation of a similar kind given to nonmanagement employees during the calendar year, or if there are no similar transfers during the year, no greater than 25 percent of the amount of any similar transfer to the insider during the calendar year before the year in which the compensation was paid.
As a result of these strict rules on the payment of retention bonuses, debtor companies generally seek to avoid the treatment of compensation presented to a bankruptcy court for approval as being subject to the retention payment rules. In the first Dana Corporation case (351 BR 96), the court concluded that a “completion bonus,” to be paid upon an executive remaining employed through the effective date of the company’s plan of reorganization, was in substance a retention payment subject to the BAPCA retention payment rules. It made this determination even though a portion of the payment turned on meeting certain performance targets. The court’s conclusion rested in large part on its view that the payments looked very likely to be made, either because they were not subject to performance standards at all or because the stated performance standards appeared to be relatively easily attainable.

The court also concluded that the BAPCA’s special restrictions on severance pay applied to compensation that was ostensibly in exchange for noncompete, where that compensation was to be paid upon an executive’s involuntary dismissal or resignation for good cause. The BAPCA severance pay rules are, like its retention pay provisions, very restrictive. They prohibit a bankruptcy court from approving a severance payment to an insider unless that payment is part of a program generally applicable to all full-time employees, and the amount of the payment is not greater than 10 times the amount of the average severance pay given to nonmanagement employees during the calendar year in which the payment is made.

There is also a “catch-all” prohibition under BAPCA that prohibits a court’s approval of payments that are “outside the ordinary course of business and not justified by the facts and circumstances of the case,” including payments for the benefit of officers, managers, or consultants hired after the filing of the bankruptcy petition.

In the second Dana Corporation decision, the company returned to the court with a modified compensation package, which the court approved. As one might expect, the compensation package had been restructured to largely avoid the application of Section 503(c). The bulk of the compensation did not, in substance, constitute retention or severance pay, and was determined by the court to be reasonable.

Lessons. The early cases interpreting the BAPCA amendments to the Bankruptcy Code suggest that courts will look to the substance of an arrangement to determine whether it is a retention payment. In particular, where compensation is framed in terms of performance standards that are, in reality, easily obtainable, a court may well treat those payments as retention compensation subject to the strict BAPCA constraints.

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A recent federal trial court decision suggests that recipients of stock option grants had better read the terms of their grants and the related plan documents! In *First Marblehead Corp. v. House*, 401 F.Supp.2d 152 (D. Mass. 2005), a financially sophisticated former executive was required to exercise his stock options within three months following his termination of employment, as required under the terms of the stock option plan document and grant, even though the executive had previously received a two-page memorandum setting forth the principal terms of the grant, which had indicated only that the options “must be exercised within 10 years of the date of grant.” There had been no mention in the memorandum of any three-month deadline for exercise following termination of employment.

After the executive received the memorandum of principal terms (and a “compensation review” worksheet, which listed the executive’s items of compensation), the company prepared the executive’s actual stock option grant. The executive asserted, and the court took as true for purposes of the employer’s motion for summary judgment, that the executive never saw the specific grant of incentive stock options nor the complete plan document prior to his leaving the company. The executive contended that he believed he could exercise his stock options at any time within the 10-year period. He indicated that no one at the company ever told him anything about time limits for exercise upon termination of employment (and the employee did not inquire about any such limits).

The court rejected the executive’s breach of contract argument that the written terms of the grant, and in particular the three-month deadline for exercise following termination, did not apply because the memorandum the executive received stated that the options had a 10-year duration. The court held that under Delaware law (which applied because the company was a Delaware corporation) the terms of the instrument approved by the company’s board of directors granting the option must control, despite any conflicting terms in the memorandum or worksheet provided to the executive. As an alternative ground for rejecting the executive’s breach of contract argument, the court concluded that the memorandum the employee received dealt only with the duration of the options, not exercisability. The court reached this conclusion even though the memorandum stated that the options “must be exercised within 10 years of the date of grant.” (Emphasis added)

The executive not only argued that requiring exercise within three months of termination was a breach of contract, he also argued under a promissory estoppel theory that he was entitled to exercise his options beyond the three month deadline. The executive asserted that he relied on the language
of the worksheet and memorandum, and in particular, their failure to state a deadline for exercise following termination. The court rejected this argument as well. Although the court acknowledged that under the doctrine of estoppel, minor extensions of an option exercise deadline may be permitted to deal with last minute emergencies, no corporate officer had made affirmative misrepresentations with respect to exercisability of the options. In addition, the court said the executive, as a sophisticated individual, should have known there was a written grant, yet he never asked for that document nor inquired about the terms of the incentive stock option upon leaving the company. The court noted as well that the memorandum described the options as “ISOs,” which the court said should have raised a red flag for the executive to further investigate the terms of the options.

In similar fashion, the court rejected a negligent misrepresentation claim made by the executive. The court concluded that this sophisticated executive had not shown that he justifiably relied on the omission from the memorandum and worksheet of information concerning the deadline for exercise.

Lesson. The lesson of this case is more for executives than for employers. And it is a simple one: recipients of stock option grants should, with the assistance of appropriate professional advisors, carefully read the terms of their grants and the terms of the underlying stock option plan document. The equally simple corollary for employers is that stock option plan documents and grants should be written carefully and precisely, because they are likely to serve as the ultimate authority concerning the terms of the options granted, particularly in cases involving Delaware corporations.

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