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Supreme Court Upholds Incentive Forfeiture

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When it comes to properly paying employees, California law presents a minefield for the unwary employer. For example, wages must be paid in cash or in a form “negotiable and payable in cash” (e.g., by check), without discount, within a specified time period after they are earned. Employees who quit or are terminated typically must be paid their final wages on their last day of employment or significant penalties may accrue. Once earned, wages cannot be forfeited, and it is illegal for an employer to recoup or collect from employees any part of wages already paid. Private agreements circumventing these rules are strictly prohibited.

On November 2, 2009, the California Supreme Court issued its decision in Schachter v. Citigroup, Inc. The Court addressed several wage payment laws. The Court’s opinion confirmed courts enforce incentive compensation arrangements according to their terms—even when those terms impose conditions that, if not satisfied, will result in forfeiture of unearned compensation.

The Facts and Lower Courts’ Decisions

David Schachter worked as stockbroker at Smith Barney, Inc. (now a subsidiary of Citigroup, Inc.) from April 28, 1992, to March 29, 1996. As part of his compensation, he chose to participate in the company’s employee stock purchase plan. Under the plan, he elected to divert a portion of his annual earnings to purchase shares in the

company’s stock at a below-market price. To encourage employee retention, the plan expressly provided that if the participating employee resigned or was terminated for cause within a two-year vesting period, the employee would forfeit the unvested stock, as well as the money used to purchase it.

In March 1996, Schachter voluntarily resigned from the company before his restricted stock vested. The company took the position that by virtue of his resignation, he forfeited all of his shares, and the money used to purchase them. Schachter sued, alleging that the plan’s forfeiture provision violated California wage and hour laws, including that the company failed to pay him wages when he resigned. Schachter’s theory was that his resignation resulted in his forfeiting “not only the shares of the restricted [company] stock [he] had purchased,” which Schachter conceded was lawful, but also the “earned but unpaid compensation” he diverted to acquire those shares.

The lower courts dismissed Schachter’s claims, concluding the company had paid him all of his “earned” wages under the plan’s terms. The Court of Appeal held that no unlawful forfeiture occurred because neither the forfeited shares, nor the funds used to purchase those shares, had been “earned” given Schachter’s voluntary resignation prior to vesting.

Schachter appealed to the Supreme Court. He argued that the company’s restricted stock plan was illegal and unenforceable under: (1) California Labor Code Sections 201 and 202, which preclude withholding of an employee’s earned wages at termination); and (2) California Labor Code Section 219, outlawing private agreements designed to circumvent these laws.

The California Supreme Court’s Decision

The Supreme Court unanimously upheld the company’s restricted stock plan. The Court first recognized that employers may prospectively alter the terms of their employees’ employment, including how employees are paid, so long as the changes do not violate the law or take away already vested amounts. The Court determined that Schachter had renegotiated the terms of his compensation—choosing to be compensated with a mix of cash and restricted stock.

The Court rejected Schachter’s Section 201 and 202 claims for unpaid wages at the time of termination. The Court held that Schachter had been paid all of his “earned” wages at the end of his employment. To determine what had been “earned,” the Court deferred to the Plan’s specific terms, to which Schachter had agreed. “The only thing that has not been ‘paid’ is something Schachter never ‘earned’ – fully vested [company] stock,” the Court wrote.

Based on its finding that the company's plan did not violate unpaid wages laws, the Court likewise held that the plan did not constitute an illegal attempt to dodge these laws under California Labor Code Section 219.

The Supreme Court also rejected Schachter's alternative argument that he was entitled to a pro-rata portion of the incentive compensation. The Court did not accept Schachter's analogy to vacation pay, which automatically vests over time. Vacation pay constitutes compensation for past services and "begins vesting [and is "earned"] as soon as the employee has performed substantial services for his or her employer." Incentive compensation, on the other hand, can be used by employers to induce future "faithful service" and employers may require employees "remain on the job" as a condition of earning it.

Schachter's Practical Lessons

The Schachter decision provides a measure of flexibility and certainty to California employers who enter into carefully worded compensation arrangements with their employees. While the decision is directly relevant to employers who maintain employee stock purchase plans that include retention-based forfeiture provisions, its reasoning extends to all incentive/bonus programs. The Schachter decision confirms an employer's right to establish forms of incentive compensation as a matter of private contract with their

employees. Compensation plans will normally be enforced according to their terms.

Employers may condition wage earning on the occurrence of events, including length of service. However, an employer's right to enforce these conditions is not unfettered. Courts historically have sought to remedy unfair forfeiture of employee incentive compensation, such as where an employee is fired to avoid paying the incentive or is otherwise kept from achieving the pre-condition through no fault of his/her own.

For example, Citigroup's plan would have paid Schachter certain compensation had he been fired without cause. The Supreme Court noted this provision was consistent with principles of contract law prohibiting one party to a contract from preventing completion by the other. The California Labor Commissioner's long-standing enforcement policy likewise instructs that employees terminated without cause may be entitled to receive some pro-rata share of the promised bonus.

This decision also affirms an employer's right to prospectively change their at-will employees' compensation level and structure, including by reducing compensation. This may be welcome news for employers struggling to pay their employees in this difficult economy. Still, employers must be mindful not to run afoul of statutes (like state minimum wage and overtime laws)

that cannot be abridged, in addition to paying the full sum of moneys already earned by employees pursuant to past or existing agreements.

Schachter underscores the importance of committing employee compensation arrangement to writing. It is important to be clear when explaining earning criteria and forfeitures. The Supreme Court was particularly swayed by fact that Schachter "knew the rules of the game" surrounding forfeiture—the company required Schachter and other plan participants to complete new plan election forms on a yearly basis, each clearly confirming the terms of stock forfeiture upon termination.

Finally, Schachter leaves unresolved an interesting issue regarding California Labor Code Section 212, which requires that all employees' wages be paid in cash or instruments "negotiable and payable in cash." Schachter and other employees participating in the company's stock incentive plan were paid in shares of restricted stock instead of by cash or check. Because unvested stock is not immediately "payable in cash," this practice would seem to violate Section 212. However, the Court of Appeal dismissed this idea, determining that payment to Schachter in shares "in lieu of cash" did not violate this statute. The Supreme Court ignored the Section 212 issue. As such, this issue remains unresolved for now.

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