



CALIFORNIA EMPLOYMENT AND LABOR UPDATE

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California Supreme Court Upholds Incentive Compensation Forfeiture

In a decision issued this week, the California Supreme Court upheld a forfeiture provision contained in many employee incentive compensation plans. *Schachter v. Citigroup, Inc.*, No. S161385 (Cal. Nov. 2, 2009). In so doing, the Court confirmed the holdings of several earlier appellate court decisions, such as *Neisendorf v. Levi Strauss & Co.*, 143 Cal.App. 4th 509 (2006).

David Schachter, the plaintiff in the case, worked as a stockbroker for Smith Barney, Inc., a subsidiary of Citigroup, Inc. at the time of the decision. Two and one-half years after being hired, Schachter voluntarily enrolled in the company's capital accumulation plan ("CAP"). Under the terms of the CAP, an employee who enrolled could elect to receive up to 25% of his cash compensation in the form of restricted shares of the company's stock at a 25% discount, which was treated as deferred income under applicable IRS regulations.

If the employee remained employed for two years following the purchase of the restricted stock, title to the shares vested fully with the employee, free of any restrictions. If the employee was involuntarily terminated without cause prior to the expiration of the two year period, the CAP provided that the employee forfeited the stock but was to be paid a cash equivalent equal to the portion of the employee's annual compensation that had been paid in the form of the forfeited stock. However, if the employee voluntarily resigned or was terminated for cause before the end of two years from date on which the stock was issued, the employee would forfeit the restricted stock – including the cash compensation used to purchase it. As the Court noted, the 25% discount in the price of the stock was specifically designed to "reflect the impact of the restrictions on the value of the restricted stock, as well as the possibility of forfeiture of restricted stock."

Schachter voluntarily resigned his employment prior to two years from the date on which he received some of his restricted stock, which resulted in the forfeiture of the stock pursuant to the terms of the CAP. He subsequently filed a class action against the company alleging violations of the California Labor Code, in particular sections 201, 202 (for wages) and 203 (for waiting time penalties), based on the company's failure to pay him at the time of his resignation the amount of cash compensation he had deferred under the CAP.

The trial court initially denied the company's motion for summary judgment. The case was then transferred to a different trial court which, upon reconsideration, granted it. The Court of Appeal affirmed, and the Supreme Court granted review.

In approving the forfeiture provisions of the CAP, the Supreme Court first upheld the broad concept that employers could lawfully provide employees with various types of compensation – some for past work and some contingent compensation for future loyalty or performance. Citing to the Division of Labor Standards Enforcement Policies and Interpretations Manual (“DLSE”) and *Neisendorf*, the Court held that contingent compensation for prospective performance, such as “efficient and faithful service” was perfectly lawful. The Court's citation to the DLSE Manual was unexpected because the Court previously had held that the Manual was an invalid underground regulation in violation of the California Administrative Procedures Act.

Quoting *Neisendorf*, the Court stated that there was no public policy “transforming a contingent expectation of receiving bonuses into an entitlement.” In light of these principles, the Court found that Schachter never “earned” his restricted stock because he never met a condition for payment: not resigning for two years after issuance. It noted: “The only thing that has not been paid is something Schachter never earned — fully vested company stock. Schachter therefore has no claim under section 201 or section 202.”

The fact that Schachter had designated actual cash compensation to purchase the stock and, as a result of his resignation, lost both the stock and the originally deferred amounts did not concern the Court. It held that there would have been nothing problematic had Schachter received his compensation entirely in cash and then used some of it to purchase restricted stock. Thus, the mere fact that Schachter and the company had agreed to collapse what could have been two lawful transactions into a single deferral based on Schachter's prospective election was not troubling. Indeed, the Court noted that this process was likely required to comply with IRS regulations concerning deferred income and had provided a significant tax benefit to Schachter.

Although the Court's decision is favorable to employers who use incentive plans similar to the one used by Smith Barney, the Court's opinion contained *dicta* that plaintiffs in future may attempt to cite. Although Schachter voluntarily resigned, the Court's opinion noted that existing law might provide that employees can not be deprived of bonuses or other compensation for which they had completed all necessary steps to earn when the employer terminates their employment without cause.

The Court's decision vindicates a policy used by many employers to incentivize their employees, though it does not necessarily address all circumstances that might lead to a valid forfeiture. Accordingly employers should remain very careful in crafting the conditions under which employees forfeit contingent compensation.

If you have questions regarding this update, please contact the Sidley lawyer with whom you normally work.

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