

News from our Employment & Labor Group

New California Supreme Court Decision *Schachter v. Citigroup* Upholds Forfeiture Provision in Key Employee Stock Purchase Plan

The California Supreme Court ruled recently that a forfeiture provision in a key employee stock purchase plan did not violate the California Labor Code. The Court upheld the forfeiture of an employee's unvested restricted stock, and the cash compensation he used to purchase the stock, under the terms of the plan because the employee resigned prior to the stock's vesting date.

Background

Citigroup employee David Schachter voluntarily participated in the company's capital accumulation plan (the "Plan"), which was available to officers and other key employees. Under the Plan, Schachter made elections to receive shares of restricted Citigroup stock at a 25% discount from market value, in lieu of a portion of his cash compensation. Schachter received voting and dividend rights in the restricted stock, but he could not sell, transfer, pledge or assign the stock for two years after the date of each stock award. The Plan provided further that if he voluntarily terminated his employment or Citigroup terminated his employment for cause prior to the two-year vesting date for any stock award, he forfeited the unvested shares and the money used to purchase them.

Schachter resigned from his Citigroup employment prior to the two-year vesting dates of each of his restricted stock awards, thereby forfeiting all his restricted shares, as well as the cash compensation used to purchase those shares. He brought a class action against Citigroup, asserting that the Plan's forfeiture provision violated

California Labor Code sections 201 and 202, which require employers to pay employees all earned, unpaid wages upon termination or resignation, and California Labor Code section 219, which prohibits agreements that circumvent the requirements of Sections 201 and 202. Schachter conceded that he was not entitled to receive the unvested shares, but claimed the Labor Code required Citigroup to pay him the amount of compensation used to purchase the forfeited shares.

The California Supreme Court upheld the forfeiture provision of the Plan, thereby affirming the trial court's grant of summary judgment for Citigroup. The Court reaffirmed that employers and employees are free to prospectively alter the terms of employment. Thus, Schachter was free to modify his compensation arrangement from all cash, to a mix of cash and incentive compensation in the form of the restricted stock. The Court then invoked the rule that an employee does not earn incentive compensation until satisfying the stated conditions to receiving the incentive compensation, which conditions often include remaining employed for a specified period of time. Schachter did not earn full rights to the restricted stock under the Plan, because he resigned from his Citigroup employment before the stock vested. Therefore, Schachter had no earned, unpaid wages outstanding upon his resignation, and his forfeiture of the restricted stock—and the cash compensation he used to purchase the stock—did not violate the Labor Code.

In reaching its decision, the Court also held that the restricted stock at issue

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constituted “wages” under California Labor Code section 200(a). The Court ruled that Citigroup had paid Schachter all earned wages, because Schachter had received the restricted stock, which carried immediate voting and dividend rights in the shares. The Court did not, however, explicitly reach the issue of whether stock granted or promised to employees in other contexts might also constitute wages under Section 200(a). In particular, the *Schachter* Court did not reach the issue of whether *stock options* constitute wages, leaving undisturbed a 1999 ruling by the U.S. Court of Appeals for the Ninth Circuit, *International Business Machines Corp. v. Bajorek*, holding that stock options are *not* “wages” under the California Labor Code.

Practical Considerations

The *Schachter* decision is important in several respects. First, it validates forfeiture provisions in a stock purchase plans similar to provisions of the Citigroup plan. Second, the Court reaffirmed the prospective and bilateral rights of employers and employees to change compensation and other terms of employment. Third, the Court endorsed the principle that employers can enforce conditions to receiving incentive compensation, such as continued employment for a specified time period. Finally, the Court’s recognition of contingent future rights as a permissible part of an employer’s compensation package may provide some indirect support for the use of clawback provisions in incentive compensation programs.

If you would like to discuss these issues further or have questions about this *Alert*, please contact one of the attorneys listed above.