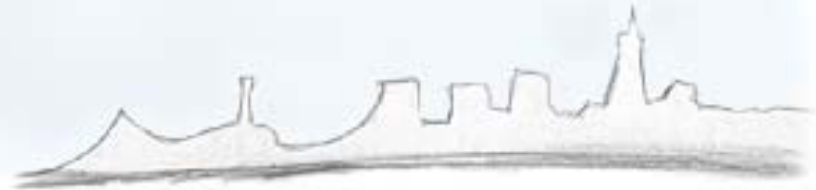


NCEO

The National Center for
Employee Ownership

LEVINE & BAKER LLP



Recent Developments in the Law of Equity Compensation

Alisa J. Baker, Levine & Baker LLP

Corey Rosen, National Center for Employee Ownership

August 10, 2006

What This Webinar Will Cover

- *Representative court decisions from 2001 through 2005; we'll pick one case with interesting facts to highlight in each area*
- *Focus is on issues related to employee-employer disputes and tax issues, with a brief discussion of family law matters*
- *We won't cover government rulings*
- *For a complete review of dozens of court cases and rulings since 2001, see the just published The Law of Equity Compensation (Baker and Rosen, National Center for Employee Ownership , 2006)*



General Contract Issues

- Waivers, Oral Modification, and Related Claims
- Inconsistencies and Ambiguities
- Ignorance Is Not Bliss
- Other Learning from Recent Case Law



Did I Really Say That?: Waivers, Oral Modification, Related Claims

Generally, written documents trump conflicting oral agreements. However, either party can sabotage a document by its behavior, including its oral communications.



Did I Really Say That?: Waivers, Oral Modification, Related Claims

Moses v. Corning (3d.Cir. 2004)(Unpublished)

- Former employee tried to exercise options 2 *years after termination*, claiming that he was relying on oral reps of in-house counsel re: length of post-term exercise period.
- Moses sued for breach of contract and promissory estoppel. At trial, summary judgement awarded to Corning on both claims. On appeal, 3d Cir remanded for trial on estoppel issue only: **in-house counsel's statements may well have given rise to reasonable reliance by Moses.**



The Humpty Dumpty Problem: Inconsistencies and Ambiguities

Document interpretation can become tricky when terms are inadequately defined or inconsistent as between the plan, the option agreement and other related contracts.

"When I use a word," Humpty Dumpty said in a rather scornful tone, "it means just what I choose it to mean--neither more nor less."

"The question is," said Alice, "whether you can make words mean so many different things."

The question is,' said Humpty Dumpty, 'which is to be master - that's all.'

*From Through The Looking Glass
by Lewis Carroll*



The Humpty Dumpty Problem: Inconsistencies and Ambiguities

Scribner v. WorldCom (9th Cir. 2001)

- Scribner tried to exercise his options after he was terminated pursuant to the sale of his subsidiary; WorldCom maintained this his options had expired because term on a divestiture constituted “cause.”
- The plan did not define “cause,” leaving that to employer discretion.
- Scribner sued for breach of contract. At trial, summary judgment to WorldCom; 9th Cir. reversed and remanded for summary judgment in favor of Scribner: **in the absence of a definition, the term must be given its common law meaning (under WA law).** (. . .and cited Humpty Dumpty!)



What You Don't Know Can Hurt You: When Ignorance Is Not Bliss

Generally, courts are not sympathetic to the argument that an employee relied to his detriment on rights he believed he had when those rights were not set out (or were contradicted) in the documents.



What You Don't Know Can Hurt You: When Ignorance Is Not Bliss

Vague v. BankOne Corporation (Del. Ch Ct. 2003), *rev'd and rem.* (Del. 2004), (Del Ch. Ct. 2006).

- Based on oral reps from BankOne, Vague believed he had an extended post-term ex. period; thus didn't exercise until 8 months after options expired.
- Vague sued on an equitable fraud/misrep theory. At trial, summary judgment to BankOne; Del. Sup. Ct. rev, rem'd for hearing on the issues. On retrial, judgment for BankOne. Ct determined that misreps could indeed have resulted in reasonable reliance. However, **any reliance was undercut by Vague's failure to open and read 2 accurate statements sent to him prior to the exp. date.**



Other Learning From Recent Case Law

- Generally, oral promises to grant options that are never reduced to writing are unenforceable.
- However, a written promise to grant equity rights (particularly phantom stock) may be enforceable even if specific grants were not made
- Employees who receive grants are expected to understand that you take a risk that equity comp may not produce results as good as straight cash comp



Employment Disputes

- Termination
- Options as Wages
- Noncompete Agreements
- Calculating Damages



Terminal Impact: Effects of Termination on Vesting

In recent years, treatment of equity has become a key component of wrongful term litigation, particularly regarding vesting and exercise rights on termination. This is a state law contract issue, as a rule.



Terminal Impact: Effects of Termination on Vesting

Harrison v. NetCentric (Mass. 2001).

- Harrison was 45% vested in restricted stock at termination. NetCentric repurchased his vested shares in accordance with the agreement.
- As part of wrongful term claim, Harrison claimed that he was owed all of his stock, alleging that the term was at least partially motivated by the desire to prevent additional vesting.
- On appeal to Mass. S.Ct., summary judgment to Netcentric. **No requirement to vest at-will employee in any more stock than contractually required at termination.**



How Much Protection? Options as Wages

The circuits are split as to whether options should be considered to be “wages” for labor law purposes or whether they are nonwage compensation, protected only by contract law. Again, this is a matter of state law.



How Much Protection? Options as Wages

Paolini v. Albertson's, Inc. (9th Cir. 2005).

- After a dispute regarding whether certain options should have been accelerated, Paolini's employment at Albertson's terminated. He was not permitted to exercise the disputed options.
- Paolini sued for wrongful term and damages, alleging that he was terminated for trying to exercise his options. D.Ct. granted summary judgment to Albertson's; 9th Cir. vacated and certified question to Idaho Supreme Court.
- **9th Cir. found that there was evidence that Paolini was fired because of his effort to exercise options, and the ultimate decision will turn on whether options are wages under Idaho law, a matter on which Idaho has no clear precedent.**



Making Loyalty Pay: Noncompete Agreements

The enforceability of noncompetes –including those that result in forfeitures of equity comp – is another matter governed by state law. The rules vary widely between jurisdictions, so beware!



Making Loyalty Pay: Noncompete Agreements

Olander v. Compass Bank (5th Cir. 2004)

- In this Catch-22 case illustrating the trickiness of non-competes, Olander was prevented from exercising options because of a noncompete agreement with his employer.
- At trial, the noncompete was held to be invalid, so Olander won. Right?
- Wrong, because his agreement said that if the noncompete was held invalid, then he had to pay back the gains from options he just was allowed to exercise.
- 5th Circuit invalidated the noncompete, but upheld the forfeiture. **A great case on the importance of careful drafting!**



How Much Is Enough: Calculating Damages

There is no uniform answer for how economic damages should be calculated on a breach of an equity compensation agreement. Courts turn to experts (and persuasive arguments by counsel) to establish a formula in each case.



How Much Is Enough: Calculating Damages

Scully v. Watts (3d Cir. 2001).

- Scully was wrongfully terminated before the end of his employment agreement, and his options were cancelled. On term date, options were worth \$531,000. 6 months later, when they would have otherwise vested, they were worth \$1,078,000.
- **Scully argued that value on date of vesting should be used; Watts argued that value should be subject to marketability discount at term date.**
- D.Ct. chose term date value, rejecting arguments for both higher and lower valuations. On appeal, aff'd by 5th Cir. (with a detailed discussion of contract damage theories generally).



It Happened One Night: Equity In Corporate Transactions

A surprising number of cases involve arguments over when and if a “change in control” has actually occurred. Courts tend to hold that a transaction has not occurred until the actual closing date.



It Happened One Night: Equity In Corporate Transactions

Bohan v. Honeywell International (8th Cir. 2004).

- Shareholder approval was obtained for Honeywell/GE merger, but European regulators did not approve and the deal fell through.
- Plaintiffs argued that under the plan, shareholder approval in itself was sufficient to trigger option acceleration.
- D.Ct held that the **merger had to be “completed” for acceleration to occur**; on appeal, affirmed by 8th Cir.



Pick Your Poison: Choice of Law Issues

- International jurisdiction
- Federal/State Preemption Issues



Getting Sick in Switzerland Is No Excuse: International Issues

Like any other contract, a stock option agreement may set out choice of law provisions that provide for jurisdiction outside of the United States.



Getting Sick in Switzerland Is No Excuse: International Issues

Oracle v. Falotti (9th Cir. 2003)

- Falotti, a Swiss citizen working for Oracle in Switzerland, had an employment agreement governed by Swiss law and an option agreement governed by California law. At the time of termination, Falotti was being treated for depression. He failed to timely exercise his options post-termination.
- Falotti filed a wrongful termination lawsuit in California based on Swiss employment law, which prohibits termination for illness and, in any event, requires two-month notice prior to any termination. Falotti argued that because of the wrongful term, Swiss law should control the stock options and result in an extension of both his post-termination vesting and exercise period.
- DCt awarded summary judgment to Oracle, affirmed by the 9th Circuit. **Without a specific choice of Swiss law in the option agreement, Swiss law employment requirements were not relevant to the operation of the option agreement.**



My Law Is Bigger Than Your Law: Federal/State Preemption Issues

Equity compensation is necessarily subject to federal and state securities laws, which may pre-empt state laws when a lawsuit is pled properly (for example, in a class action). Another area of potential pre-emption arises from ERISA.



My Law Is Bigger Than Your Law: Federal/State Preemption Issues

Falkowski v. Imation Corp. (9th Cir. 2003)

- Plaintiffs were Cemax employees who exchanged Cemax options for Imation options in a merger between the companies. The following year, Imation sold Cemax to Kodak, taking a \$200 million earnings write-off. Plaintiffs had 30 days post-closing to exercise the now devalued options.
- Plaintiffs sued for fraud under state law, but Imation successfully removed the lawsuit to federal court, arguing that the state fraud claim was pre-empted by the federal Securities Litigation Uniform Standards Act (SLUSA).
- 9th Cir. affirms removal. **Options fit squarely into SLUSA: “unlike stock bonus plans, stock options involve contracts to sell stock for money at a later date.”**



What Mine Is Yours: Family Law Issues

Divorce cases raise difficult state law issues on how to allocate equity awards between former spouses. Vested awards are generally split along with the rest of the property, but unvested awards raise stickier issues. Most states have some version of the “time rule,” but applications of the rule are all over the map.



What Mine Is Yours: Family Law Issues

Examples of allocations for state law purposes:

- Former spouse not entitled to half of options granted just before divorce (NJ 2005)
- Options granted day after divorce becomes final not subject to division (Mo 2004)
- Stock options for future performance not spouse's separate property (Fla 2003)
- Post-separation, pre-dissolution options are marital property (Conn 2002)
- Unvested options are assets includible in marital estate (Mass 2001)



Gotcha: Federal Tax Issues

Many recent U.S. Tax Court cases represent attempts for taxpayers to get around the unfortunate results of the dot-com boom and bust. The rapidity with which stock prices fell during this period left many taxpayers with unanticipated tax bills and disputes that are still wending their way through the tax system.



Gotcha: Federal Tax Issues

Hilen v. Commissioner (2005)

- Taxpayer Hilen used third-party nonrecourse loans (collateralized with the underlying stock) to finance his options in 1999. On exercise, he reported the spread. By the time he was able to sell the stock, it had declined below the strike price. The loan was called, he filed for bankruptcy and defaulted.
- Taxpayer argued that his use of a nonrecourse loan resulted in a failure to transfer property under Section 83 of the Code. Therefore, he never received the stock and should not have to pay tax on the spread. His stock value dropped sharply after exercise, his loan was called, and he filed for bankruptcy.
- U.S. Tax Court held that Section 83 in this context applies to company-financed debt, not third-party debt. Options are taxable at exercise regardless of how financed by taxpayer.



Gotcha Again: State Tax Issues

As one might expect, two states with high income taxes and active business communities – California and New York – face the most appeals from taxpayers on equity-related issues.



Gotcha Again: State Tax Issues

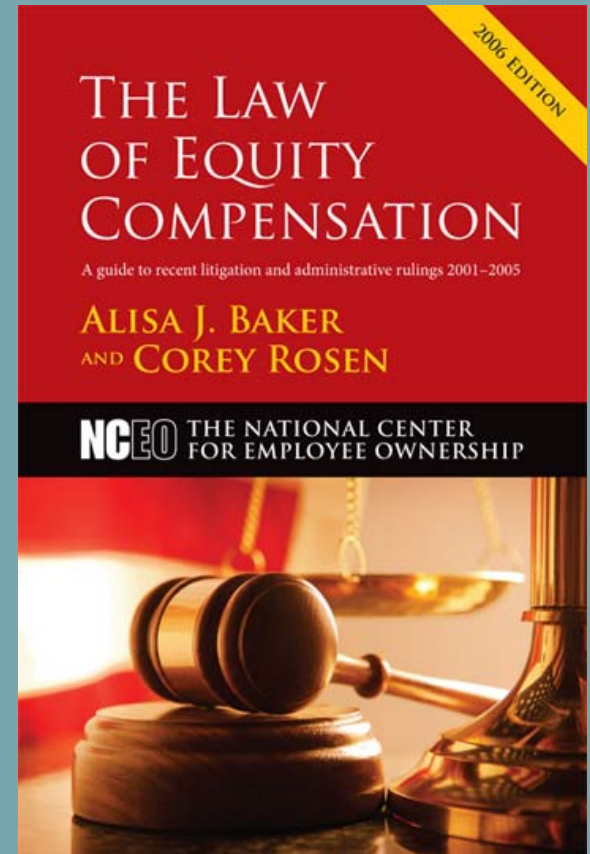
- Examples from NY and CA:
 - CA: Disposition of options by nonresident subject to tax on CA source income. *In re Cower (2005)*. Nonresident must pay CA tax on option spread for options exercisable with respect to services provided in the CA, even if the options were exercised outside of the state after taxpayer's move.
 - NY: Gain on stock options must be allocated between NY and WA. *In the Matter of the Petition of E. Randall Stuckless and Jennifer Olson (2004)*. Taxpayer employed in NY at time of option but residing in WA at time of exercise must allocate source income between the two states pro-rata to days worked in each state over the total term of the award.



Further Reading

Alisa J. Baker and Corey Rosen, *The Law of Equity Compensation* (NCEO, August 2006), \$25 for NCEO or NASPP members. Contains summaries and descriptions of over 125 legal cases and over 50 government rulings between 2001 and 2005.

For details or to order, see:
<http://www.nceo.org/pubs/law-equity.html>



About the Speakers

Alisa J. Baker is a partner in Levine & Baker LLP (www.levinebakerlaw.com), a San Francisco law firm specializing in employment law and executive compensation. For more than twenty years, Alisa has advised clients on executive and equity compensation matters, including negotiating employment-related agreements, representing founders in M&A transactions, and providing expert consulting services for equity-related litigation. Along with her many other publications, she is the author of *The Stock Options Book*, CEPI's core text, and co-author of the new NCEO treatise, *The Law of Equity Compensation*.

Corey Rosen is the executive director and, in 1981, cofounder of the National Center for Employee Ownership (www.nceo.org). He has a PhD in political science and previously taught college and worked in the U.S. Senate. He is the author or co-author of numerous books on employee ownership and over 100 articles, and co-author (with John Case) of *Equity: Why Employee Ownership is Good for Business* (Harvard Business School Press, 2005). He serves on the Board of Directors of the Great Place to Work Institute (creators of the "Best Companies in America to Work For" lists) and the Advisory Board of the Certified Equity Professional Institute. He is regularly quoted and interviewed on employee ownership in the major media.



Contact Information

Alisa J. Baker

Levine & Baker LLP

One Maritime Plaza, Ste 400

San Francisco, CA 94111

abaker@levinebakerlaw.com

T: (415) 391-3510

F: (415) 391-8488

Corey Rosen

National Center for Employee Ownership

1736 Franklin Street, 8th Floor

Oakland, CA 94612

crosen@nceo.org

T: (510) 208-1314

F: (510) 272-9510

