

STOCK OPTION FORFEITURE PROVISIONS (Excerpt from the Nov-Dec '95 issue of *The Corporate Executive*)

Our discussion in our September-October 1995 issue (at pg 4) of Lee Iaccoca's experience with Chrysler's stock option forfeiture provision, as well as a subsequent (October 22) New York Times article, apparently have raised interest in adding non-compete forfeiture provisions to stock options.

Extant Provisions

We could not find any survey out there addressing non-compete forfeiture provisions in stock option plans. (We have asked the NASPP to address this, not only in their upcoming Annual Stock Plan Features Survey, but to add to the NASPP's new Stock Plan Features Database a category for forfeiture provisions.) Our gut feel is that, although several well known companies have such provisions, a surprisingly large number of companies do not. And, those provisions we have seen do not always appear to have been carefully crafted.

One explanation for why non-compete forfeiture provisions are not more prevalent is that, unfortunately, option plans and agreements are often cookie-cutter versions of previously used plans and agreements. Hopefully, the Iaccoca publicity and the following piece will cause issuers and compensation committees and their counsel to focus on this important (but apparently neglected) aspect of option grants.

Our Survey. Our own informal survey of readers and compensation consultants revealed the following 20 companies with forfeiture provisions. We would like to thank Steve Sabow of William M. Mercer and Richard Freedman of Ayco for searching their files and databases to help us locate plans with forfeiture provisions.

Company Proscribed Events Remedy

American Home Products compete; unavailability for consultation; causing substantial harm to interests of company forfeit unexercised options

AMP compete; act against interests of company post-termination exercise period terminates

Chrysler render services to others without written consent of company; conduct adversely affecting company lose right to exercise options after termination of employment

Coastal compete; fraud, embezzlement, felony, etc.; disclose trade secrets forfeit options and restricted stock, as well as "exercised options and any performance-based stock awards"

Del Electronics termination for cause convert ISOs to NQSOs; forfeit unexercised options, option stock and "any gains realized by virtue of a receipt of an option"; cancel or annul grants

Delta Air Lines compete within two years after early retirement forfeit unexercised options and repay amounts realized on post-termination exercises

Dow Chemical (i) leave company within 1 year after exercise (if exercise within 5 years of grant); (ii) compete; (iii) activity harmful to interests of company If (I), repay

option gain at exercise; if (ii) or (iii), forfeit unexercised options and, as to any option exercised within 3 years prior to proscribed activity, forfeit option gain

General Motors compete lose right to exercise

Goodyear compete within 18 months after termination forfeit option gains and economic value of other awards realized within 6 months prior to termination

IBM (and Mattel) compete; disclose confidential information; failure to assign invention to company forfeit option or award if activity occurs prior to exercise; rescission if occurs within 6 months after exercise (rescind by paying cash or returning shares, ie, of equal value). Company has two years after exercise or delivery to assert rescission.

Medtronic compete; disclose proprietary information; violate company policies return/forfeit option gains, option stock, restricted stock and performance shares received within 6 months prior to termination of employment. Company must exercise forfeiture right within 15 months of termination of employment.

State Street Boston compete; unavailability for consultation forfeit unexercised options or unearned performance units

Sunbeam-Oster compete within 2 years after termination; recruit employees; disclose or misuse confidential information. Sunbeam also has a separate confidentiality forfeiture provision for directors. forfeit options and restricted stock which vested within 2 years prior to termination, stock purchased upon exercise of such options, and proceeds from sale of such option stock or restricted stock.

Taubman compete forfeit unvested options

Toro compete; violate confidentiality agreements forfeit unexercised options and gains on exercises during the 12 months prior to termination

US Banknote compete; unavailability for consultation forfeit unexercised options

Wendy's disclose confidential information or trade secrets; breach contracts with or fiduciary obligations to company; trade on inside information forfeit unexercised options and unearned performance awards

Western Atlas compete; disclose confidential information options become null and void 3 months after termination of employment

Westinghouse compete; unavailability for consultation forfeit unexercised options and unvested restricted stock, etc.

Types of Provisions

These forfeiture provisions can be broken down into three categories:

Options forfeited

This is essentially the Chrysler approach (although technically Chrysler's is not a *non-compete* provision-see above description). This type of provision would prevent, *e.g.*, an executive who has left a company and gone to work with a competitor from being able to exercise an option (*i.e.*, during the post-termination exercise period). But, it would not prevent an executive from exercising prior to leaving to go to a competitor.

Both (i) options forfeited and (ii) gains from exercises subject to recapture, or exercises subject to rescission

This is essentially the Goodyear and IBM approach. It addresses the problem of the

executive who exercises and then leaves, by obligating the executive to disgorge the exercise date spread or (in some cases) even to return the shares (apparently without regard to the executive's payment of the exercise price). But, the Goodyear and IBM provisions address only a relatively short period that is subject to recapture and, therefore, would not apply where an executive who exercises all his/her options, say, seven months prior to terminating, then leaves to compete or discloses trade secrets to a competitor. On the plus side, the Goodyear/IBM approach (which is triggered where the executive leaves within six months of exercise) would cover proscribed acts during the period of 18 months (Goodyear) or two years (IBM) after termination of employment.

□ **The Dow Chemical Approach**

We still prefer the Dow Chemical approach (discussed in our May-June 1989 issue at pg 4) over the others we have seen. We like the fact that the time period for recapturing gains covers exercises within three years prior to a proscribed event. Moreover, Dow has a set-off collection provision which enables the company to deduct the amounts subject to recapture from any amounts owed by the company to the executive. Dow also (as do many of the other companies) gives the board or compensation committee discretion in enforcing the provision. And, Dow has an additional provision which we like a lot, triggering recapture where an executive exercises and then leaves within one year (not necessarily going to a competitor).

Our Model Forfeiture Provision

The following suggested provision is based on Dow's provision but (a) adds concepts from forfeiture provisions of other companies broadening the scope of proscribed activities, and (b) extends the period covered (for both the proscribed activity and the remedy) to also include three years after termination, and the original term of the option. [It should be appropriate if the company has granted a ten-year option that the executive at least abide by the forfeiture provision during the entire option term.]

ABC, Inc. Stock Option Forfeiture Provision

The purpose of the Company's stock option plan is to attract, retain and reward employees, to increase stock ownership and identification with the company's interests, and to provide incentive for remaining with and enhancing the value of the Company over the long-term. In return for granting this option to you, please acknowledge by signing below that you have read and agree to the following:

1. Forfeiture of option gain if you leave the Company within one year after exercise. If you exercise any portion of this option and you leave the employment of the Company within [one year] after such exercise for any reason except death, disability or normal retirement, then the gain represented by the mean market price on the date of exercise over the exercise price, multiplied by the number of shares you purchased (" option gain"), without regard to any subsequent market price decrease or increase, shall be paid by you to the Company.
2. Forfeiture of option gain and unexercised options if you engage in certain activities. If, at any time within (a) the [ten year] term of this option or (b) within [three years] after termination of employment or (c) within [three years] after you exercise any portion of

this option, whichever is the latest, you engage in any activity in competition with any activity of the Company, or inimical, contrary or harmful to the interests of the Company, including, but not limited to: (i) conduct related to your employment for which either criminal or civil penalties against you may be sought, (ii) violation of Company policies, including, without limitation, the Company's insider trading policy, (iii) accepting employment with or serving as a consultant, advisor or in any other capacity to an employer that is in competition with or acting against the interests of the Company, including employing or recruiting any present, former or future employee of the Company, (iv) disclosing or misusing any confidential information or material concerning the Company, or (v) participating in a hostile takeover attempt, then (1) this option shall terminate effective the date on which you enter into such activity, unless terminated sooner by operation of another term or condition of this option or the Plan, and (2) any option gain realized by you from exercising all or a portion of this option shall be paid by you to the Company.

3. Right of Set-off. By accepting this agreement, you consent to a deduction from any amounts the Company owes you from time to time (including amounts owed to you as wages or other compensation, fringe benefits, or vacation pay, as well as any other amounts owed to you by the Company), to the extent of the amounts you owe the Company under paragraphs 1 and 2 above. Whether or not the Company elects to make any set-off in whole or in part, if the Company does not recover by means of set-off the full amount you owe it, calculated as set forth above, you agree to pay immediately the unpaid balance to the Company.

4. Compensation Committee Discretion. You may be released from your obligations under paragraphs 1, 2 and 3 above only if the Compensation Committee (or its duly appointed agent) determines in its sole discretion that such action is in the best interests of the Company.

[Editor's Note: It should be understood that the above model provision is intended to further a dialogue between management and company counsel as to the scope and eventual wording which the company may adopt for its own purposes consistent with its employee (director) stock plans, including other provisions (e.g., change in control and governing law-see Enforceability, below), and should not be adopted verbatim.]

Signing The Forfeiture Provision

Surprisingly, many companies do not require their executives to sign their stock option agreement even where there is a forfeiture provision. To make sure that the provision has the desired effect on, and is appreciated by, executives (and to increase enforceability), we would want those intended to be covered by the provision to sign it. [In addition to key executives, the company may want to include important technical and sales personnel.] Companies may also wish to provide a copy of the agreement in the package of exit materials furnished to executives upon termination. [Note, that the form of forfeiture provision should be filed as a Form 10-K exhibit, either separately or as part of the form of stock option agreement.]

Enforceability

Our research has uncovered only two reported cases involving stock option non-compete provisions (although other cases address *pension* benefits). In both cases (see *Raybuck v USX*, 961.F. 2d 484 (4th Cir. 1992), and *York v Actmedia Inc.*, 1990 WestLaw 4:760 (USDC SDNY, March 3, 1990), the company prevailed. Whereas the court in *Raybuck* simply analyzed the case in contractual terms, the court in *York* addressed whether the non-compete forfeiture clause was reasonable and concluded:

The stock option provisions were not part of plaintiff's [executive's] basic compensation, nor were they part of a pension plan, subject to the strong protections and legal policies described in *Post*. In the view of the court, it was perfectly reasonable for plaintiff and defendant to agree, as they did, that, in consideration of the stock options, plaintiff would refrain from certain steps injuring the business of defendant. The provision was not indefinite, it was for a period of two years. There is no effort by defendant to enforce paragraph 11 by way of attempts to compel plaintiff to give up his new business or to recover damages against him for his new endeavors. All that is being done is to assert that plaintiff is not entitled to the stock options on account of his violation of paragraph 11.

Although some of our brethren in California (which has perhaps the toughest approach to non-compete provisions) might conclude that Section 16600 of the California Business & Professions Code (" Every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void") would make enforcement in California doubtful, we think a strong argument for enforceability can be made even in California. As the New York court did in *York*, we believe a California court could distinguish between (i) restricting a former employee from future employment versus imposing economic consequences for engaging in proscribed activities, and (ii) the forfeiture of vested benefits under a pension plan from stock options, and conclude that an option forfeiture provision is not a contract in " restraint of trade" .

[As has been recently reported, Lee Iacocca has sued Chrysler (in California) over its forfeiture provision.]

Taxation

Option stock which is subject to a forfeiture provision should not be treated as restricted stock for tax purposes. Such a provision would not constitute a " substantial risk of forfeiture" under §83(c).

Implementing the Provision

Although, generally, it would not be feasible to unilaterally impose a forfeiture provision on already outstanding grants, companies might consider conditioning future grants on executives' agreeing to apply the provision to prior grants (or at least to unvested grants). In the event a plan amendment is necessary, shareholder approval should not be required under Rule 16b-3 because the provision reduces rather than increases benefits. (See Romeo and Dye's *Section 16 Treatise and Reporting Guide* at §13.03(3).)

A Final Word

Notwithstanding the fact that the question of enforceability could be raised in some jurisdictions, we believe forfeiture provisions can serve a salutary effect and should be considered for inclusion in option agreements of key personnel. It is entirely appropriate that options (and restricted stock grants and similar awards), which are intended to serve as incentive compensation and to increase an executive's ties to the company and further the long-term interests of the company, contain forfeiture provisions addressing terminations and actions by executives which are against the interests of the company.