ww&p Walder Wyss & Partners
Attorneys at Law

NewsLetter

No 44 September 2003

Forfeiture Clauses in Incentive Compensation Plans

Employee share and stock option plans, often referred to as "incentive compensation plans" ("ICPs"), raise a variety of legal and tax issues. The tax benefits of ICPs were reviewed in our NewsLetter No 39 in February of this year. In this issue we examine labour law issues arising from the use of so-called "forfeiture" provisions in some ICPs. An aim of these clauses is to ensure that the intended incentive is given to motivate and retain employees. The pitfalls of forfeiture clauses are described below, as well suggestions for achieving the desired business result while reducing the risk of violations of applicable labour laws.

Forfeiture Clauses

ICPs often provide that a "grant" or "award" of shares or stock options ("Securities") will be forfeited if the recipient's employment is terminated. A wide variety of such clauses can be found, but a commonly used provision states that the granted Securities will be forfeited if they are not "vested" with the employee when the notice terminating the employee's employment was given. Another form of this provision states that the Securities will be held in an escrow account and that the ownership of the Securities will revert to the employer if the employee's employment ends before a specified date. A third variation of this clause requires the employee to transfer the Securities or their value in cash to the employer if the employee's employment ends before a specified date. Each of these forms of "forfeiture" clauses raises significant labour law issues, some of which are discussed below.

by Dr. Ueli Sommer
+41 1 265 75 16
usommer@wwp.ch

Are the Securities "Wages" and to what Extent are Related Labour Laws Applicable?

It is generally assumed that the grant of Securities is to be classified legally as part of the employee's wages or salary *(Lohn)*. The High Court of the Canton of Zurich, however, has indicated in a recent decision (ZR 120 (2003) No 5) that there is some room for the argument that some provisions of the labour law do not apply to certain types of compensation for the senior management of a company if such compensation is made in additon to a fixed salary and bonus. Further, some scholars argue that grants of Securities, which are an incentive for future performance, are not part of wages because wages are by definition a payment for services already performed. Unfortunately, no decision of the Swiss Federal Supreme Court has yet addressed this interesting question.

The Issue of a Retention of Wages

Article 323a of the Swiss Code of Obligations ("CO") provides that an employer may retain a portion of an employee's wages only to the extent that the retention (i) has been expressly agreed in the employment contract, (ii) is common practice, (iii) is specified in a standard employment contract approved by the government *(Normalarbeitsvertrag)* or (iv) is specified in a collective employment contract *(Gesamtarbeitsvertrag)*. The amount retained may not be more than 10% of the employee's wage due on a payment day and in any case not more than one week's wage unless provided otherwise in a *Normalarbeitsvertrag* or a *Gesamtarbeitsvertrag*. Grants of securities under ICPs often exceed 10% of an employee's overall remuneration and therefore could be challenged as a violation of Article 323a of the CO. To avoid this pitfall, the grant of Securities should specify that the employee does not have a "vested" (absolute contractual) right to own the Securities until they are transferred unconditionally to the employee in accordance with the terms and conditions of the grant. This formulation distinguishes between wages which are contractually owed on a current basis and which therefore could be subject to retention and a grant of Securities which, if the relevant conditions are not fulfilled, may never be payable and therefore can not be retained.

Requirements to Repay Salary

It is uncertain and debated amongst scholars that a requirement to repay a part of paid salary is legally binding. Even if a repayment obligation is valid, its

enforcement may be difficult: the employee may no longer own the Securities or may not have sufficient cash to repay an amount equivalent to the value of the Securities. As with the retention of wages issue, it is important to specify that the employee does not have an absolute contractual right to own the Securities until they are transferred unconditionally to the employee in accordance with the terms and conditions of the grant. If this is done, issues relating to repayment will be avoided.

Notice of Termination of Employment

Swiss labour law provides that the notice periods for the termination of employment must be the same for both employee and employer (Article 335a of the CO). Case law also holds that provisions which seriously interfere with the right to issue a termination notice are deemed void. For example, it is not permissible for the employee to suffer any financial detriment (except the loss of salary) if he or she terminates the employment relationship in accordance with the terms of the labour contract. An argument can be made on the basis of these principles that forfeiture clauses impermissibly limit the freedom of the employee to terminate the employment relationship. There is a countervailing argument that the courts generally accept limitations on the termination right based on valid reasons. For example, case law recognises that the payment of a bonus can be made conditional on the fact that notice of termination has not been given, a principle which also should apply to grants of Securities under ICPs. It should be noted that it is not sufficient to make only the actual transfer of legal title to the Securities conditional on the continuing existence of the employment relationship and the lack of a termination notice. Rather, these conditions must already apply to the grant of the Securities, i.e. the Securities will not be granted if as of the specified date for the delivery of the Securities a termination notice has been given by either the employer or employee.

Conclusion

Although ICPs established under Anglo-Saxon legal systems make a distinction between the *grant* of the Securities and the *vesting* of the right to receive them, i.e. the unconditional acquisition of all legal claims to such Securities (legal ownership and the right to sell the shares or exercise the option), neither "grant" nor "vesting" are defined terms under Swiss law. It is therefore important to specify in the employment contract or other document notifying the employee of the "grant" of Securities, that:

– he or she does not have an enforceable claim to receive the securities unless all of the conditions of the "grant", including the absence of a termination notice, have been fulfilled on the date the transfer of the shares or options is to occur. This approach was upheld by the High Court of the Canton of Zurich in the decision mentioned earlier;

– the Securities are granted as an incentive for future performance and not as payment for work already performed.

This approach makes the frequently used "forfeiture" clause unnecessary and it avoids the pitfalls of using such clauses discussed above.

It should not be forgotten that under Swiss law a condition is deemed fulfilled if its satisfaction has been prevented by a party acting in bad faith (Article 156 of the CO). Thus, it is accepted that an employer may terminate the employment relationship to protect its own interests without acting in bad faith. If a termination is notified only to prevent the employee from acquiring an unconditional legal claim under an ICP, however, such conduct could be considered bad faith, and if so, the employee would nevertheless acquire an unconditional legal claim to the granted Securities.

ww&p **Walder Wyss & Partners**
Attorneys at Law

Münstergasse 2
P.O. Box 2990
CH-8022 Zurich
Phone +41 1 265 75 11
Fax +41 1 265 75 50
reception@wwp.ch
www.wwp.ch

London Representative Office
9 Gray's Inn Square
London WC1R 5JQ
Phone +44 20 7405 2043
Fax +44 20 7405 0605