Employee Stock Options: Is Complete Forfeiture of Non-Vested Stock Options Fair and Equitable When an Employee is Involuntary Terminated Without Cause

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EMPLOYEE STOCK OPTIONS: IS COMPLETE FORFEITURE OF NON-VESTED STOCK OPTIONS FAIR AND EQUITABLE WHEN AN EMPLOYEE IS INVOLUNTARILY TERMINATED WITHOUT CAUSE?

I. INTRODUCTION

Ann is a research scientist employed by a small public biotechnology company. Yesterday, she learned that as a result of a larger than anticipated year-end earnings loss, the company is planning to cut next year's research budget by twenty-five percent. To achieve the needed budget cut, the company decided to reduce its work force by terminating two research programs. Ann was informed that her research project is one of the two being dropped; consequently, she will lose her job. Although Ann has made substantial contributions to the company in terms of her research, the company has determined that the market potential of the product area she has been researching is limited. Her effective date of termination is January 31, 1993.

On March 1, 1991, Ann received an incentive stock option grant of 10,000 shares from the company. Under the terms of the grant, Ann's stock options were subject to a three year vesting schedule. According to this schedule, fifty percent of the options (5,000 shares) vest March 1, 1993 and the remaining fifty percent (5,000 shares) vest March 1, 1994. The grant states that if Ann's employment is terminated for any reason, she will forfeit any options.

1. The "grant" is the stock option agreement which sets forth the terms of the plan, including the number of options granted, the exercise price, and the vesting schedule. See Herbert Kraus, Stock Options, in 2 START-UP COMPANIES: PLANNING, FINANCING AND OPERATING THE SUCCESSFUL BUSINESS § 13.08 (Richard D. Harroch ed., 1991); Liposome Technology, Inc., 1987 Employee Stock Option Plan, Incentive Stock Option Agreement [hereinafter LTI Stock Option Plan] (on file with SANTA CLARA LAW REVIEW).


3. Vested is defined as "having the character or given the rights of absolute ownership; not contingent; not subject to be defeated by a condition precedent." BLACK'S LAW DICTIONARY 1563 (6th ed. 1990).
not yet vested. Since Ann’s effective termination date is January 31, 1993, under the vesting terms of the stock option grant, she forfeits the entire grant. The exercise price of Ann’s stock options is $5.00 per share, and the closing stock market price for the company’s stock was $15.00 per share on December 31, 1992. The effect is that Ann loses a potential profit of $50,000 by not being able to exercise her stock options and sell the shares on the public market at the current price.

In the foregoing hypothetical, unless Ann had a provision in her stock option grant specifically providing for pro rata or accelerated vesting of her stock options in the event of an involuntary termination, her option grant is subject to full forfeiture, because only vested options, of which she has none, are exercisable. This comment addresses the issue of whether it is fair and equitable for an employee, such as Ann, to entirely forfeit a stock option grant when that employee is involuntarily terminated, without cause, just prior to a stock option vesting date.

First, this comment describes stock options and why stock option grants are commonly used, explores how stock options are characterized in relationship to other employee benefit plans, compares vesting of stock options and vacation pay in terms of what happens upon employment termination, and examines how the statutory and case law deals with equity problems raised by the forfeiture

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4. Only vested options are fully owned by the employee and not subject to repurchase by the company; they can be exercised (bought from the company) for a stated exercise price. The exercise price is set forth in the stock option agreement and is based on the fair market value of the stock at the time of grant. See I.R.C. § 422(b)(4) (1992); Kraus, supra note 1, § 13.08.

5. The potential profit is the difference between the exercise price and the market price, times the number of shares exercised and sold. ($15 - $5 = $10; $10 x 5,000 shares = $50,000).

6. “To divide, share, or distribute proportionately.” BLACK'S LAW DICTIONARY 1220 (6th ed. 1990). For example, if Ann had worked 11 months out of the 12 necessary for vesting, she would receive eleven-twelfths of the shares.

7. In accelerated vesting, any non-vested options would fully vest as of the termination date. For example, if Ann worked 11 months out of the 12 required for vesting, the full 12 month amount would vest for the year she was terminated.

8. “Without cause” means that the employee was laid off because of company economic or business factors rather than individual performance based factors. In general, “without cause” implies that the employee had no control over the reasons for her termination; “with cause” means that the employee was directly responsible (through her own actions) for the termination.

9. See infra part II.A.

10. See infra part II.B.

11. See infra parts II.C.1-2.
of non-vested vacation pay benefits.\textsuperscript{12}

Next, the comment discusses the inequities of stock option forfeiture provisions,\textsuperscript{13} explores inconsistencies in the case law regarding forfeiture,\textsuperscript{14} and analyzes the chances for recovery by a plaintiff such as Ann.\textsuperscript{15} The recovery analysis section specifically discusses bad faith termination,\textsuperscript{16} stock options and whether they are deferred compensation or compensation for future services,\textsuperscript{17} and equitable theories of recovery.\textsuperscript{18}

Finally, this comment proposes that a new provision of the California Labor Code be enacted to provide for pro rata vesting of stock options when an employee is involuntarily terminated, without cause, before the vesting date of the employee's stock options.\textsuperscript{19} Pro rata vesting, rather than accelerated vesting, is proposed as a solution, because pro rata vesting is fair to both the company and the employee. As discussed later in this comment, accelerated vesting favors the employee, whereas forfeiture favors the company. Such a labor code provision will provide certainty in the law and protect employees from losing valuable, earned benefits when they are terminated because of circumstances beyond their control.

\section*{II. \textbf{Background}}

\subsection*{A. Stock Options: What They Are and Why They Are Used}

Stock options are defined as the right to buy a designated stock, if the holder of the option so chooses, at any time within a specified period at a determinable price.\textsuperscript{20} Stock options are generally divided into two types, statutory and nonstatutory.\textsuperscript{21} Incentive stock options (ISOs) are statutory options designed to provide selected employees with the opportunity to acquire stock in the employing company on a favorable tax basis.\textsuperscript{22} Nonstatutory stock options (so-called non-qualified stock options) are also designed to provide certain employees with the opportunity to acquire stock in the employing company,

\begin{thebibliography}{99}
\bibitem{12} See infra parts II.D.1-2.
\bibitem{13} See infra part III.A.
\bibitem{14} See infra part IV.A.
\bibitem{15} See infra parts IV.B-D.
\bibitem{16} See infra part IV.B.
\bibitem{17} See infra part IV.C.
\bibitem{18} See infra parts IV.D.1-5.
\bibitem{19} See infra part V.
\bibitem{20} \textit{Black's Law Dictionary} 1418 (6th ed. 1990).
\bibitem{21} Bouymaster & Frank, supra note 2, § 14.02[3].
\bibitem{22} Bouymaster & Frank, supra note 2, § 14.02[3][a].
\end{thebibliography}
but unlike incentive stock options, these options have no tax benefits.\(^\text{23}\)

For either type of stock option, no income tax consequences ensue at the time the options are granted.\(^\text{24}\) Non-qualified options are taxed when the employee exercises the option. The employee recognizes compensation income (ordinary income), measured by the difference between the exercise price and the fair market value of the stock at the time of exercise.\(^\text{25}\) At that time, the corporation also receives a comparable compensation tax deduction.\(^\text{26}\) ISOs are taxed somewhat differently.\(^\text{27}\) At the time of exercise, the employee recognizes no compensation income.\(^\text{28}\) If, after exercise, the employee holds the stock for over a year before selling, capital gains income is recognized.\(^\text{29}\) If the stock is sold before the one year holding period expires, the employee is taxed in the same manner as non-qualified options.\(^\text{30}\)

Since capital gains are now taxed at virtually the same rate as ordinary income,\(^\text{31}\) there are few real differences between these two types of stock options. Nonetheless, statutory stock options or ISOs, can still provide a benefit to the employee since, as a general rule, no tax is imposed at the time of exercise.\(^\text{32}\) In contrast, tax generally is imposed at the time a nonstatutory option is exercised.\(^\text{33}\) Overall, the compensation benefits of stock option plans can be substantial: stock options do not use up the employer’s or an employee’s cash and no compensation expense is incurred by the employer.\(^\text{34}\)

Company stock option plans are used to attract and retain exec-

\(^{23}\) Bouymaster & Frank, supra note 2, § 14.02[3][c].
\(^{25}\) Id.
\(^{26}\) Id.
\(^{27}\) Id.
\(^{28}\) Id. If the employee does not immediately sell the stock after exercise, any future gain or loss is measured from the exercise price.
\(^{29}\) Id. The necessary holding period for capital gains treatment is two years after the option was granted and one year after it was exercised. I.R.C. § 422(a)(1) (1992); Kraus, supra note 1, § 13.02[8].
\(^{30}\) Soule, 723 F. Supp. at 1142. The gain is taxed as ordinary income. See Kraus, supra note 1, §13.02[8].
\(^{31}\) Kraus, supra note 1, § 13.01; Bouymaster & Frank, supra note 2, § 14.02[3]. The maximum capital gains tax rate is 28% and the maximum tax rate on ordinary income is 31%. I.R.C. §§ 1(a)-(e), (h) (1992). However, since a 31% rate is applied only at the highest income levels, for most taxpayers, the capital gains tax rate would be identical to the ordinary income tax rate of 28%.
\(^{32}\) Bouymaster & Frank, supra note 2, § 14.02[3].
\(^{33}\) Bouymaster & Frank, supra note 2, § 14.02[3].
\(^{34}\) Kraus, supra note 1, § 13.01.
utive, key, or qualified personnel, and such options, when granted, are considered a form of compensation. The primary objective of a stock option plan is to motivate an employee to work for the long-term success of the company by providing equity ownership in the company. In some areas of the country, notably California's Silicon Valley, stock options are considered to be essential elements of a start-up company's compensation package. Stock option plans are particularly attractive to start-up companies, because they provide a well recognized means of compensating employees without depleting valuable cash reserves, they offer upside potential to employees without downside risk (until exercise), and they motivate employees to work harder toward the success of the company.

B. Characterization of Stock Options: Deferred Compensation or Compensation for Future Services?

Characterizing stock options as either deferred compensation or compensation for future services is an important exercise in evaluating whether pro rata vesting is justified in cases of involuntary termination. Deferred compensation vests as it is earned and is analogous to a condition subsequent situation, whereas a future services requirement sets up a condition precedent situation. Nonperformance of a condition subsequent does not prevent a right from vesting, since a condition precedent could prevent vesting, since

36. Bouymaster & Frank, supra note 2, § 14.02[1]. Since the object of a stock option plan is to entice the employee to remain with the company on a long-term basis, such plans typically have an initial period of employment required for any vesting (typically one year to several years). Bouymaster & Frank, supra note 2, § 14.02[2]. For example, a typical plan may provide for a three, four, or five year vesting schedule (i.e., the options vest one-third on the second anniversary of employment and two-thirds over the next two years; or vest 25% on the second anniversary, then 25% each year thereafter for the next three years; or vest 20% on the second anniversary, then 20% each year thereafter for the next four years). Kraus, supra note 1, § 13.08; see also LTI Stock Option Plan, supra note 1.
37. Bouymaster & Frank, supra note 2, § 14.02[1]. See infra note 125 and accompanying text.
38. Bouymaster & Frank, supra note 2, § 14.02[3].
40. It would not be unreasonable to interpret eligibility requirements as a condition precedent before vacation pay vests, if the sole purpose of vacation pay were to encourage employees to stay in the position for a specified time period. Id. at 127. If, however, vacation pay is not viewed as an inducement for future services, but rather is judged to be compensation for past services, there is no longer a justification for requiring employees to remain for the entire year. Id.
41. Id. at 126.
42. Id.
the employment conditions would need to be met before the options are vested.

In In re Marriage of Hug, a California appellate court indicated that stock options may be classified as compensation for past, present, or future services. Characterizing stock options as compensation for future services relies on the general rule that option agreements must ordinarily be supported by consideration and that, in practice, the consideration will usually be supplied in the form of continued services. However, for many small companies without substantial cash resources, stock options may provide a means of attracting employees willing to render services for modest compensation in return for future rewards on a potentially tax-favored basis.

Although a company may wish to provide an incentive for future services in such a situation, the primary goal appears to be deferring compensation for present services.

Similarly, in Bertero v. National General Corp., the court found that the stock options at issue were intended to be additional compensation to the plaintiff. The court determined that the stock options served not only as an added reward for valuable services to be rendered, but also they encouraged increased current effort on the part of the employee to achieve added profit for the corporation.

As a basis of comparison, vacation pay is considered a form of deferred compensation. In this respect, vacation pay is similar to pension benefits or bonus pay, other forms of deferred compensation. The question of whether stock options should be treated as deferred compensation or compensation for future services will be

43. 201 Cal. Rptr. 676 (Ct. App. 1984).
44. Id. at 679.
45. Id. at 680.
46. Id.
47. Id.
49. Id. at 723.
51. Although an employee does not earn the right to a full pension until he or she has completed the prescribed period of service, some pension rights actually have been earned as soon as substantial services for the employer have been performed. Kern v. City of Long Beach, 179 P.2d 799, 803 (Cal. 1947). In a sense, the employee is not fully compensated upon receiving his or her salary payment because, in addition, certain pension benefits have also been earned, and the payment of these benefits is deferred to a future date. Id.
52. A federal district court found the plaintiff entitled to an accrued bonus, because it considered the bonus compensation for services already performed. Harden v. Warner Amex Cable Communications, Inc., 642 F. Supp. 1080, 1096 (S.D.N.Y. 1986).
53. Suastez, 647 P.2d at 125.
further examined in a later section of this comment.\textsuperscript{54}

C. Vesting of Employee Benefit Rights

1. Stock Options

To be a valid contract, a stock option plan must contain consideration which passes to the corporation, and which can take one of many forms, including the retention of services of a valued employee, or the gaining of services from a new employee.\textsuperscript{55} Stock option plans have been found invalid when the stock options were exercisable upon grant, without an employment contract or other consideration to insure that the corporation would receive the benefits contemplated.\textsuperscript{56} Therefore, to encourage the employee to continue working for the success of the company and to insure that the employer receives the service benefits bargained for, vesting restrictions are commonly imposed in stock option grants.\textsuperscript{57} It is well-settled law that where the optionee is required to remain employed by the corporation for an extended period of time, no legal attack may be successfully made upon the validity of such options.\textsuperscript{58}

The vesting schedule is controlled by the stock option grant,\textsuperscript{59} and stock option vesting typically occurs over a period of several years.\textsuperscript{60} The grant may provide for forfeiture of non-vested options if the employee's employment terminates for any reason, or it may pro-

\begin{itemize}
\item \textsuperscript{54} See infra part IV.C.
\item \textsuperscript{55} Beard v. Elster, 160 A.2d 731 (Del. 1960). Delaware case law is cited as applicable law, because many companies located in California are incorporated in Delaware. The validity of issuance of stock options to employees of a Delaware corporation is governed by Delaware corporation law. Elster v. American Airlines, 100 A.2d 219 (Del. Ch. 1953).
\item \textsuperscript{56} Frankel v. Donovan, 120 A.2d 311 (Del. Ch. 1956); Kerbs v. California E. Airways, 91 A.2d 62 (Del. 1952). In contrast, stock options plans have also been held valid even though the plan did not require the optionee to make any agreement to remain in the company's employ and the option granted could be exercised at any time after the date of the grant. Siemerman v. Ackerman, 184 A.2d 28, 30 (Del. Ch. 1962) (citing Beard v. Elster, 160 A.2d 731 (Del. 1960)). However, such option plans were allowed, because the board of directors determined that the plan would result in the retention of the services of the valued employees, and the court did not want to second guess the independent business judgment of the board. Id. at 31. Although such factors may not be determined by the court to be legal consideration, there is no doubt that they constitute the real consideration sought by the corporation in return for such options. Id. at 32 (citing Kaufman v. Schoenberg, 91 A.2d 786 (Del. Ch. 1952)). Thus, as long as the court finds that the company is in some way assured it will receive what it expects from the employee, stock options grants are valid both with and without vesting schedules.
\item \textsuperscript{57} See supra note 36.
\item \textsuperscript{58} Hoffman v. Dann, 205 A.2d 343 (Del. 1964).
\item \textsuperscript{59} See supra note 1.
\item \textsuperscript{60} See supra note 36.
\end{itemize}
vide for pro rata or accelerated vesting under certain circumstances.\textsuperscript{61} However, the grant usually will not provide for early vesting in the event of a voluntary termination or an involuntary termination with cause and, subsequently, any non-vested options are forfeited in such circumstances.\textsuperscript{62}

General contract principles provide that by accepting the stock option grant, the employee agrees to be bound by the terms of the grant.\textsuperscript{63} In \textit{Fredericks v. Georgia-Pacific Corp.},\textsuperscript{64} a federal district court stated, "[a]lthough a broad forfeiture clause in an employment or options contract may work a harsh result, a court must act only upon the language of the written contract."\textsuperscript{65} This holding was reached even though the employee's termination was induced by humiliation and harassment calculated to force his resignation.\textsuperscript{66}

In contrast, when an employee was terminated through bad faith on the part of the employer, the employee was allowed to recover.\textsuperscript{67} In \textit{Gaines v. Monroe Calculating Machine Co.},\textsuperscript{68} a New Jersey appellate court held that a discharge without cause prior to the expiration of a five year vesting period, especially a discharge made in bad faith for the purpose of destroying the employee's right to the option, did not permit termination of the option.\textsuperscript{69} Thus, where an employee is discharged without just cause and for the purpose of depriving the employee of the right to exercise his stock purchase option, the employer is liable for damages.\textsuperscript{70} Similarly, in \textit{Lucas v. Seagrave Corp.},\textsuperscript{71} recovery was allowed for pension benefits where there was bad faith on the part of the employer in termi-

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\textsuperscript{61.} See Kraus, \textit{supra} note 1, § 13.08. Circumstances triggering accelerated vesting may be that the company is acquired or that the employee is involuntarily terminated without cause. Kraus, \textit{supra} note 1, § 13.08.

\textsuperscript{62.} See Kraus, \textit{supra} note 1, § 13.08.

\textsuperscript{63.} This principle was upheld in a Minnesota Supreme Court case. Knudsen v. Northwest Airlines, Inc., 450 N.W.2d 131 (Minn. 1990). The \textit{Knudsen} court held that where an employee enters into a stock option agreement that is granted on certain terms and conditions, he or she is bound by those conditions. \textit{Id.} at 133. However, the court explained that this holding does not mean it would not recognize situations in which a broad termination provision in a stock option contract would be subject to a good faith finding of cause before the stock rights could be denied. \textit{Id.}

\textsuperscript{64.} 331 F. Supp. 422 (E.D. Pa. 1971).

\textsuperscript{65.} \textit{Id.} at 427.

\textsuperscript{66.} \textit{Id.} at 428.


\textsuperscript{68.} \textit{Id.} at 179.

\textsuperscript{69.} \textit{Id.} at 185.

\textsuperscript{70.} Haag v. Int'l Tel. and Tel. Corp., 324 F.2d 205, 208 (7th Cir. 1963).

\textsuperscript{71.} 277 F. Supp. 338 (D. Minn. 1967).
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nating employment.\textsuperscript{72}

In cases where the terms of the contract may be ambiguous, a court will consider the circumstances of the termination.\textsuperscript{73} In \textit{Langer v. Iowa Beef Packers, Inc.},\textsuperscript{74} a federal court of appeals permitted the plaintiff to exercise his stock options after the defendant sold its plant to another corporation and assigned the plaintiff's employment contract to that corporation, even though the option contract stated that the options would terminate in the event the optionee ceased to be an employee of the defendant.\textsuperscript{75} The court noted that the sale of the defendant's business was an extraordinary contingency which was not anticipated by the parties and not contemplated in the option contract.\textsuperscript{76} Since the contract was silent as to such an event, the court construed the ambiguity in the optionee's favor and permitted recovery.\textsuperscript{77}

2. Vacation Pay

The vesting of vacation pay is controlled by statute in California.\textsuperscript{78} Section 227.3 of the California Labor Code provides that "whenever a contract of employment or employer policy provides for paid vacation, and an employee is terminated without having taken off his vested vacation time, all vested vacation shall be paid to him.

\textsuperscript{72} A federal district court cited Lucas as a recent example where discharged employees were allowed to recover forfeited pension plan rights on the basis of quasi-contract, even though they were precluded from recovering under the terms of the contract itself: [A] class action was brought on behalf of 65 former employees against their former employer to recover their forfeited interest in the defendant's non-contributory pension plan. Under the terms of the plan, the employees were only entitled to pension benefits if they continued in employment until retirement. In Lucas, the employer engaged in a mass firing of the plaintiffs and thus precluded them from fulfilling this condition. Nonetheless, the court permitted quasi-contractual recovery on the theory that the employer had unjustly benefited from the plaintiff's forfeiture in the pension fund. Fredericks v. Georgia-Pacific Corp., 331 F. Supp. 422, 430 (E.D. Pa. 1971) (citing Lucas v. Seagrace Corp., 277 F. Supp. 338 (D. Minn. 1967)).

In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") makes it unlawful for an employer to discharge a participant in a benefit plan "for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan." Titsch v. Reliance Group, Inc., 548 F. Supp. 983, 985 (S.D.N.Y. 1982) (citing 29 U.S.C. § 1140 (1982)). Thus, an employee discharged before his or her retirement rights vest may sue to redress a violation of § 1140. \textit{Id.}

\textsuperscript{73} Fredericks, 331 F. Supp. at 423.

\textsuperscript{74} 420 F.2d 365 (8th Cir. 1970).

\textsuperscript{75} \textit{Id.} at 367-69.

\textsuperscript{76} \textit{Id.} at 369.

\textsuperscript{77} \textit{Id.}

\textsuperscript{78} CAL. LAB. CODE § 227.3 (Deering 1992).
as wages at his final rate in accordance with such contract of employment or employer policy." 79 As interpreted by the California Supreme Court in Suastez v. Plastic Dress-Up Co., 80 vacation "vests" under section 227.3 as labor is rendered. 81 The Suastez court held as follows:

The right to a paid vacation, when offered in an employer's policy or contract of employment, constitutes deferred wages for services rendered. Case law from this state and others, as well as principles of equity and justice, compel the conclusion that a proportionate right to a paid vacation vests as the labor is rendered. Once vested, the right is protected from forfeiture by section 227.3. On termination of employment, therefore, the state requires that an employee be paid in wages for a pro rata share of his vacation pay. 82

Thus, in California, as vacation pay is accrued and earned, it vests, and once vacation pay is vested, the vested right is protected from forfeiture. 83 Other types of benefit plans also may vest prior to reaching a specified date 84 or accrue as services are rendered and thus be entitled to pro rata vesting. 85

D. Is Recovery Possible When Vesting Schedules are Imposed?

Before California Labor Code section 227.3 was enacted, California courts applied principles of equity and fairness to allow laid-off employees to recover pro rata vacation benefits in certain circumstances. 86 The theories and relevant cases are discussed below. 87 Eq-

79. Id.
80. 647 P.2d 122 (Cal. 1982).
81. Id. at 128.
82. Id. (emphasis added).
83. Other jurisdictions have also held that employees have a vested right to a pro rata share of vacation pay because the right vests as services are rendered. Amalgamated Butcher Workmen Local Union No. 641 v. Capital Packing Co., 413 F.2d 668 (10th Cir. 1969); Textile Workers Union of America v. Paris Fabric Mills, Inc., 92 A.2d 40 (N.J. Super. Ct. App. Div. 1952).
84. The right to pension benefits vests upon accepting employment even though the right to immediate payment may not mature until certain conditions are satisfied. Suastez v. Plastic Dress-Up Co., 647 P.2d 122, 125 (Cal. 1982) (citing Miller v. State, 557 P.2d 970, 974 (Cal. 1977)).
85. A federal district court considering the case of a forfeited bonus stated that "if employment is terminated by the act of the employer through no fault of the employee, the employee should be entitled to a proportionate share of the bonus, according to the time served, even though there was no time fixed for the duration of the employment, and it could, therefore, be terminated at will." Harden v. Warner Amex Cable Communications, Inc., 642 F. Supp. 1080, 1096 (S.D.N.Y. 1986) (quoting Annotation, 28 A.L.R. 346 (1924)).
86. Suastez, 647 P.2d at 127.
suitable principles have also been used to provide recovery in pension benefit vesting cases.\textsuperscript{88}

1. \textit{Frustration of Purpose}

The California Supreme Court, in \textit{Posner v. Grunwald-Marx, Inc.},\textsuperscript{88} recognized that the "frustration of purpose" doctrine can afford relief in recovering pro rata vacation benefits.\textsuperscript{90} The \textit{Posner} court stated that if the purpose of requiring employment on a certain date was to induce employees to remain employed, it may reasonably be argued that the purpose of the contingency was frustrated by the closing of the plant and that the employees should be excused from performance of the condition precedent.\textsuperscript{91}

2. \textit{Substantial Performance}

California courts have also allowed recovery for vacation pay if the employee has substantially performed, despite the fact that contract eligibility requirements were not met.\textsuperscript{92} In \textit{Division of Labor Law Enforcement, Department of Industrial Relations v. Ryan Aeronautical Co.},\textsuperscript{93} substantial performance was found and vacation pay recovered where an employee was discharged through no fault of his own, with only five more working days left to complete his required year of employment.\textsuperscript{94} However, substantial performance was not found in \textit{Division of Labor Law Enforcement, Department of Industrial Relations v. Mayfair Markets},\textsuperscript{95} where an employee was

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\textsuperscript{87} See infra notes 88-97 and accompanying text.  
\textsuperscript{89} 363 P.2d 313 (Cal. 1961).  
\textsuperscript{90} \textit{Id.} at 324-25. However, the frustration of purpose doctrine has not been discussed by a court in a stock option context.  
\textsuperscript{91} \textit{Id.}  
\textsuperscript{92} Suastez v. Plastic Dress-Up Co., 647 P.2d 122, 127 (Cal. 1982). A substantial performance theory has also been used to recover bonus pay: The plaintiff was employed by the defendant to serve for a period of one year. He was to receive a bonus if he remained in the employment for the entire year. After serving all but a few weeks of the required term of employment his services terminated under circumstances held to constitute a discharge without cause. The plaintiff was permitted to recover the bonus.  
\textsuperscript{93} 236 P.2d 236 (Cal. App. Dep't Super. Ct. 1951).  
\textsuperscript{94} \textit{Id.} at 237-38.  
\textsuperscript{95} 227 P.2d 463 (Cal. App. Dep't Super. Ct. 1951).
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terminated because the business was sold; he had been employed only ten months and was entitled to vacation pay after twelve months of employment. What is surprising about the two cases mentioned above is that they were decided by the same court within several months of one another. Consequently, it is not clear how close in time the employee must be to the vesting date before achieving substantial performance status.

III. STATEMENT OF THE PROBLEM

A. Inequities in Stock Option Vesting Upon Termination

As suggested by the hypothetical situation described above, inequity and unfairness in stock option vesting may result when employees are involuntarily terminated without cause. This problem is particularly disturbing in the case of an unsophisticated employee who, without the advice of a lawyer, may not foresee the potential forfeiture problems associated with the vesting/termination provisions of a stock option grant before signing it. Furthermore, even if the employee is sophisticated about such contract matters, stock option grants may not be open to negotiation. Typically, the employee either accepts the grant or forgoes the right to be granted any stock options. The terms of the grant are drafted by the company and its lawyers, and once ISO plans are in place, it can be difficult for an employee to negotiate or alter the terms. Thus, if the grant does

96. Id.
97. Both cases were heard by the Appellate Department, Superior Court, San Diego County, California. Mayfair Markets was decided Feb. 14, 1951 and Ryan Aeronautical Co. was decided Sept. 28, 1951.
98. See supra part I.
99. This assertion is based on the fact that ISO plans are controlled by statute. If an employee stock option plan is to achieve the special tax treatment afforded an ISO, it must satisfy several conditions imposed by federal tax law: 1) the options must be granted pursuant to a stock option plan and may not be granted more than 10 years after the plan was adopted by the employer; 2) the plan under which the ISO is granted must have been approved by the company's shareholders within 12 months of its adoption by the board of directors; 3) the ISO must provide that it cannot be exercised more than 10 years after the date it was granted; 4) the options holder must have remained in the continuous employ of the company or its subsidiaries from the date the ISO was granted until not more than three months before the date on which it is exercised; 5) an ISO must be non-transferable; 6) the exercise price of an ISO must not be less than the fair market value of the stock subject to the options at the time the options are granted; 7) the amount of ISOs that may be exercised by an employee must be less than the dollar quantity limits imposed by the IRS; and 8) the shares purchased must be held at least two years after the option was granted and at least one year after it was exercised for capital gains treatment. Kraus, supra note 1, § 13.08. Because the ISO plan requires stockholder and board approval, once a plan is in place, it can only be amended with the necessary
not provide for accelerated or pro rata vesting upon termination, an employee could forfeit an entire stock option grant just before the options vest if he or she is terminated due to an unexpected layoff.

The existing case law which discusses the vesting of stock options and other employee benefits at termination is inconsistent. Some courts provide equitable remedies under certain circumstances; however, most courts look to the language of the contract, particularly in stock option disputes. Moreover, not only are courts inconsistent in how they apply equitable remedies among the different types of employee benefits (i.e., stock options, pensions, vacation pay, and bonus pay), but also the remedies vary within a specific type of employee benefit. Since stock options are granted by contract, they are often treated differently than vacation and bonus pay upon termination, although all are arguably awarded to employees for similar purposes.

The problem presented in this comment is whether it is fair and equitable for an employee to forfeit non-vested stock options upon an involuntary, without cause termination. The California legislature dealt with a similar problem when it enacted section 227.3 of the Labor Code to mandate pro rata vesting of vacation pay upon termination. Thus, the question is whether the vesting schedule set forth in a stock option grant should be pro rated (like vacation pay) in cases where the optionee (the employee) has been involuntarily terminated, without cause, from the company before the vesting date of the options. The answer to this question will affect the way termination clauses are drafted and enforced in stock option plans.

B. Relevance of Issue to Legal Community

A clear solution to this problem would assist corporate, employee benefit, and executive compensation lawyers in drafting stock option plans and in advising companies which are planning a downsizing, reduction in force, or layoff. This issue is particularly critical for practitioners who counsel start-up, high technology companies, since these companies commonly grant incentive stock options to key

approvals. Kraus, supra note 1, § 13.08.
103. CAL. LAB. CODE § 227.3 (Deering 1992).
employees.¹⁰⁴ Such companies may have been adversely affected by the recent economic recession, prompting them to consider a reduction in force to counteract declining profits. It is likely that many of the employees who would be affected in such a termination plan are key management, professional, and technical people with incentive stock option grants from the company.

If a company, by terminating employment, forces its employees to forfeit their stock options shortly before the stock option vesting date, such a forfeiture may increase the potential for harsh feelings towards the company and the likelihood of subsequent lawsuits. However, since no California statutory law currently governs this issue and California and federal case law in the area is limited,¹⁰⁶ the outcome of such a lawsuit is uncertain. Moreover, there is conflict within the existing case law regarding whether the grant (the contract) controls or whether equitable principles should be applied in the cases of without cause, involuntary termination.

IV. Analysis

Returning again to the hypothetical situation of Ann, the biotechnology research scientist who lost her job in a company downsizing and, as a result, forfeited her right to any stock options vesting after her termination date,¹⁰⁶ what right, if any, does Ann have to either a remedy of specific performance to reinstate her options or money damages for the market value of the options? In addition, what chances for recovery does the case law offer to Ann? The remainder of this comment will explore and analyze the issues raised by these questions.

A. Inconsistent Case Law

Since courts commonly will look to the contract (the stock option grant or agreement) rather than fashion an equitable remedy,¹⁰⁷ Ann’s chances for recovery under the existing case law are probably slim, unless she can show bad faith termination on the part of her employer. Ann’s grant specifically stated that non-vested options will

¹⁰⁴. See infra note 128.
¹⁰⁵. It is possible that this issue has not yet been litigated because many start-up high technology companies may not have experienced the need for downsizing until the last several years.
¹⁰⁶. See supra part I.
be forfeited if she is terminated for any reason. Therefore, if a court strictly follows the contractual language, Ann’s options would be subject to forfeiture. Nonetheless, some courts have applied the principles of equity and fairness to allow vacation pay recovery to laid-off employees under certain circumstances.\textsuperscript{108}

Although the case law is inconsistent in applying equitable remedies, and such remedies have not generally been applied in stock option cases, if an analogy can be made from vacation pay to stock options, there is a chance that Ann could recover her forfeited stock options on a theory of substantial performance\textsuperscript{109} or frustration of purpose.\textsuperscript{110} This analogy is discussed in a later section of this comment.\textsuperscript{111} In addition, there may be other equitable theories that could entitle Ann to recovery; these theories also will be discussed.

B. \textit{Employer’s Bad Faith}

Ann’s best chance of success in reinstating her forfeited options is to demonstrate a bad faith termination on the part of the company, since pro rata vesting is allowed when a company terminates employment in bad faith.\textsuperscript{112} She would have to prove that the company either deliberately terminated her employment to deprive her of the stock options,\textsuperscript{113} or be able to prove wrongful termination by some other means. However, if there is no evidence in writing, the company’s intention to deprive Ann of the options or to discriminate against her may be very difficult to prove, particularly where there has been a company-wide general layoff for economic reasons. Therefore, if bad faith on the part of her employer cannot be shown, Ann’s alternatives are limited. Based on the inconsistency in the case law, the chances of a successful recovery are unclear.

\begin{itemize}
  \item \textsuperscript{108} Suastez v. Plastic Dress-Up Co., 647 P.2d 122, 127 (Cal. 1982).
  \item \textsuperscript{109} \textit{Cf. id.} at 127 (applying a substantial performance theory to allow recovery of vacation pay).
  \item \textsuperscript{110} \textit{Cf. id.} at 127-28 (applying a frustration of purpose theory to allow recovery of vacation pay).
  \item \textsuperscript{111} \textit{See infra} part IV.C.
  \item \textsuperscript{113} In \textit{Gaines}, a discharge made in bad faith to destroy the employee’s stock options was found to be a sufficient cause of action, even though the option agreement stated that the employer could repurchase the option if employment terminated “voluntarily or involuntarily” within five years. \textit{Gaines}, 188 A.2d at 179.
\end{itemize}
C. Deferred Compensation: Stock Option/Vacation Pay Analogy

As discussed previously, an issue critical to determining whether Ann can recover a pro rata amount of her stock options is whether those options are considered a form of deferred compensation or compensation for future services. The California Supreme Court has stated that vacation pay is deferred compensation. Accordingly, in attempting to make an analogy from vacation pay to stock options, the purpose of the stock option grant must be determined.

The controlling California case on the issue of whether stock options are considered deferred compensation or compensation for future services is a community property marital dissolution case, In re Marriage of Hug. The court in Hug held that because the purposes underlying a stock option grant can differ, the facts of each case must be considered in deciding whether stock options are compensation for past, present, and/or future services. Stock option agreements ordinarily must be supported by consideration and, in practice, consideration would usually be supplied by the employee in the form of continued services. But the assertion that stock options are earned exclusively by future services is weakened somewhat in light of the flexibility and variety of option plans, as well as the differences in the size and financial circumstances of the offering company. The Hug court declined to find that stock options are earned exclusively by future services, even though most plans emphasize the incentive aspect of the options. Instead, the court found that the stock options at issue in the case were deferred compensation.

The Hug court reasoned that for the smaller company, the company without substantial cash resources, or the company in distressed circumstances, stock options may provide a means of attracting strong management talent willing to render its services for modest current compensation in return for substantial future rewards on a tax-favored basis. Thus, the primary goal of such

114. See supra notes 39-54 and accompanying text.
117. Id. at 679.
118. Id. at 680.
119. Id.
120. Id. at 680-84.
121. Id. at 683.
122. Id. at 680.
stock options is to defer compensation for present services. In *Hug*, the plaintiff employee made a critical career move by giving up substantial benefits with his former company, IBM, to join his current company, Amdahl. The stock options appeared to be a key inducement to the employee for making the move; hence, the court inferred that the Amdahl stock options to some extent replaced the benefits given up at IBM. Consequently, the court found the facts supported an implied finding that the stock options were earned from the commencement of employment and concluded that the options were deferred compensation for present services.

More information about the purpose of Ann’s stock option grant is required if *Hug* is applied to the aforementioned hypothetical. For example, it is typical in small biotechnology companies, especially when recruiting experienced executives and scientists from large pharmaceutical companies, to offer stock options as a replacement for the more substantial salary and benefits that the employee often receives from the larger company. With limited resources in the early years, the small company usually cannot compete with larger, well-established companies in a recruiting capacity without offering a stock option incentive plan to the desired employee. If the above described “replacement” occurred in Ann’s case, she would have a good argument that at least some portion, if not all, of the stock options granted to her were deferred compensation rather than compensation for future services.

The concept of stock options as compensation exclusively for future services distinguishes stock option plans from other types of employee benefit plans. Vacation pay is considered deferred compensation which vests as it is earned. Similarly, the rights to pension benefits are deferred compensation and vest upon the acceptance of employment, even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied. However, bonus plans may be more like stock options and could

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123. Id.
124. Id. at 682.
125. Id.
126. Id. at 682-83.
127. See supra part 1.
128. The executive and high level technical personnel on the start-up team frequently demand equity compensation in some form, and the start-up venture which is not prepared to include equity participation in its compensation program may find it difficult to attract the managerial and technical talent it needs. Kraus, supra note 1, § 13.01 (1990).
130. Id. at 125 (citing Miller v. State, 557 P.2d 970, 974 (Cal. 1977)).
probably be analyzed as either deferred compensation\textsuperscript{131} or compensation for future services,\textsuperscript{132} depending on the purpose of the bonus plan.

If stock options are considered exclusively deferred compensation, then there is sufficient legal precedent to support pro rata vesting.\textsuperscript{133} As deferred compensation, the termination date does not affect vesting, because the employee actually earns and vests a percentage of the stock options each day worked.\textsuperscript{134} In contrast, if stock options are considered exclusively compensation for future services, all future service must be completed before vesting occurs. Consequently, if any portion of the stock options are compensation for future services, additional legal theories are needed to provide support for pro rata vesting of stock options upon involuntary termination.

D. Compensation for Future Services: Equitable Theories for Recovery

1. Substantial Performance

California courts have allowed recovery for vacation pay despite the fact that the contract eligibility requirements were not met if the employee had substantially performed his or her duties under the contract.\textsuperscript{135} Substantial performance of a contract is shown when: 1) a party has made an honest endeavor in good faith to perform his or her part of the contract; 2) the results of that endeavor are beneficial to the other party; and 3) such benefits are retained by the other party.\textsuperscript{136} This doctrine is intended to prevent unjust enrichment.\textsuperscript{137} It provides that where a contract is intended for an agreed upon exchange


\textsuperscript{132} "Bonus and profit-sharing plans are a common device for rewarding incentive and industry, retaining competent executives, and paying additional compensation in a manner having favorable tax consequences." Hainline v. General Motors Corp., 444 F.2d 1250, 1253 (6th Cir. 1971). Under the General Motors Plan in \textit{Hainline}, bonus awards were made for both past services and anticipated future employment. \textit{Id}. Therefore, the beneficiary of a bonus has a vested right to receive bonuses awarded as long as he or she remains employed. \textit{Id}.


\textsuperscript{134} \textit{See Suastez}, 647 P.2d at 127. "If some share of vacation pay is earned daily, it would be both inconsistent and inequitable to hold that employment on an arbitrary date is a condition precedent to the vesting of the right to such pay." \textit{Id}.

\textsuperscript{135} \textit{Id}.

\textsuperscript{136} \textit{BLACK'S LAW DICTIONARY} 1429 (6th ed. 1990).

\textsuperscript{137} \textit{See infra} part IV.D.2.
of two performances, substantial performance, rather than literal performance, is sufficient to entitle a party to recovery.\textsuperscript{138}

If stock options are considered compensation for future services, the argument can be made that Ann has substantially performed her end of the contract. As set forth in the stock option grant, fifty percent of Ann's stock options were to vest after two years of service. Based on her effective termination date, Ann fell short of the option vesting date by only one month. Therefore, she has performed twenty-three of the twenty-four months of service required by the stock option grant.

In \textit{Division of Labor Law Enforcement, Department of Industrial Relations v. Ryan Aeronautical Co.},\textsuperscript{139} substantial performance of the contract was found where an employee was discharged, through no fault of his own, with only five more working days left to complete the required year of employment that entitled him to vacation pay.\textsuperscript{140} Conversely, in \textit{Division of Labor Law Enforcement, Department of Industrial Relations v. Mayfair Markets},\textsuperscript{141} substantial performance was not found and no vacation pay was awarded where an employee was terminated because the business was sold.\textsuperscript{142} The employee had served ten of the twelve months required of him to qualify for vacation pay.\textsuperscript{143} Although these two cases were decided by the same court,\textsuperscript{144} they do not provide clear guidelines for the determination of substantial performance under an employment contract.

In \textit{Ryan Aeronautical}, the contract was ninety-eight percent performed,\textsuperscript{145} whereas in \textit{Mayfair Markets} the contract was eighty-three percent performed.\textsuperscript{146} If a similar mathematical analysis is applied to Ann's case, her contract was ninety-six percent performed.\textsuperscript{147} Certainly, this level of completion could be factually construed as substantial performance by a court. However, finding substantial performance is a discretionary, fact-based decision that

\begin{footnotes}
\footnote{138. \textit{BLACK'S LAW DICTIONARY} 1429 (6th ed. 1990).}
\footnote{139. 236 P.2d 236 (Cal. App. Dep't Super. Ct. 1951).}
\footnote{140. \textit{Id.}}
\footnote{141. 227 P.2d 463 (Cal. App. Dep't Super. Ct. 1951).}
\footnote{142. \textit{Id.}}
\footnote{143. \textit{Id.} at 464.}
\footnote{144. \textit{See supra} note 97.}
\footnote{145. The percentage is obtained by dividing 51 weeks by 52 weeks. \textit{Ryan Aeronautical Co.}, 236 P.2d at 237.}
\footnote{146. The percentage is obtained by dividing 10 months by 12 months. \textit{Mayfair Mkts.}, 227 P.2d at 464-66.}
\footnote{147. The percentage is obtained by dividing 23 months by 24 months. \textit{See supra} part I.}
\end{footnotes}
varies from court to court and case to case. In addition, there is no indication that the California Superior Court which decided Ryan Aeronautical and Mayfair Markets is representative of other courts. Thus, in stock option vesting cases where the employee has nearly reached the vesting date at the time of termination, a theory of substantial performance may provide recovery, but the results this method produces are inconsistent at best. It would be unwise for a terminated employee to depend on such an unreliable theory of recovery as his or her sole means of reinstating forfeited stock options.

2. Unjust Enrichment

The unjust enrichment doctrine is the general principle that one party should not be permitted unjustly to enrich himself at the expense of another, but should be required to make restitution of or for property or benefits received, retained, or appropriated, where it is just and equitable.\(^{148}\)

In *Lucas v. Seagrave Corp.*,\(^{149}\) pension benefits were awarded to employees on an unjust enrichment theory.\(^{150}\) Sixty-five employees were fired just before they reached the date entitling them to pension benefits.\(^{151}\) The employees contended their pension constituted a form of compensation that they were induced to rely upon, that they did rely to their detriment, and, consequently, that Seagrave was unjustly enriched.\(^{152}\) The court stated:

If a plaintiff who has breached a contract by failure to fulfill a condition may recover for the benefit he confers, it would seem equitable that employees, who failed to perform the condition of the pension plan (continued employment until retirement) because of a group termination, should be entitled to an amount equal to the benefit conferred on an employer. The employees' failure to fulfill the conditions of the pension contract is not willful, indeed, it is quite involuntary. The employer is not in a position to argue that he is harmed by a non-performance of the pension conditions, in fact, he causes it. Yet the employer retains the full benefit of the employee's past service and secures favorable tax treatment as well as the recapture of the accumulated pension credits created by forfeitures.\(^{153}\)

150. *Id.* See *supra* note 72.
151. *Id.*
152. *Id.* at 342.
153. *Id.* at 344-45.
Thus, quasi-contractual recovery was held to be available to the employees.\textsuperscript{154}

In the case of a stock option forfeiture, the company has reaped the benefits of an employee's hard work, creative ideas, and commitment. In return, the employee loses valuable stock options and does not get his or her part of the bargain. In the hypothetical, Ann spent several years working for the company and made significant scientific contributions. However, if the company was ultimately able to become successful, Ann's contributions to the company would be worthless in terms of her equity ownership in the company. Moreover, Ann may have taken a below-market salary in the hope that her contributions to the company would be compensated through an increased stock value.\textsuperscript{155} But according to the terms of her option grant, Ann will lose her right to company stock, even though the company has had the benefit of her services. Thus, by allowing vesting of Ann's stock options, the company makes restitution for the benefits it has received from Ann's services.

3. \textit{Frustration of Purpose}

Under the frustration of purpose doctrine, a party to a contract will be relieved of the duty to perform when the objective purpose for performance no longer exists due to reasons beyond the party's control.\textsuperscript{156} In \textit{Posner v. Grunwald-Marx, Inc.},\textsuperscript{157} the court stated that "if the purpose of requiring employment on a certain date was to induce employees to remain in employment, it may reasonably be argued that the purpose of the contingency was frustrated by the closing of the plant and the employees should be excused from performance of the condition precedent."\textsuperscript{158}

Although \textit{Posner} is a vacation pay case, the doctrine of frustration of purpose is applicable to stock option vesting. Stock option vesting schedules (restrictions) are typically used to encourage an employee to continue working for the success of the company,\textsuperscript{159} and these vesting schedules require employment on a certain date. Hence, if Ann intended to remain with the company until her vesting date and the layoff was an event entirely out of Ann's control (i.e., not based on poor performance), then the purpose of the stock option

\textsuperscript{154} Id. at 345.
\textsuperscript{155} See supra part IV.C.
\textsuperscript{157} 363 P.2d 313 (Cal. 1961).
\textsuperscript{158} Id. at 324-25.
\textsuperscript{159} Bouymaster & Frank, supra note 2, § 14.02[2].
grant vesting schedule was frustrated by the layoff and Ann should be excused from performance (i.e., remaining employed until her vesting date).

4. Promissory Estoppel

Promissory estoppel arises when "a promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise."\(^{160}\) If the company imposes a stock option vesting schedule on an employee, expecting that the employee will make a substantial effort to remain employed on the vesting date, and the employee makes the effort by not voluntarily terminating his or her employment, the elements of promissory estoppel are met. This theory is especially fitting if the employee gave up other employment offers so that he or she would be employed on the vesting date and thus be eligible to exercise the stock options. If the employee relies to his or her detriment (i.e., forgoes other employment opportunities) on the promise of stock option vesting and then loses the options by a means outside her control, the injustice of the forfeiture can only be cured by allowing the employee to exercise the options.

A promissory estoppel theory has not been used by courts in relationship to vacation pay or stock option vesting, possibly because promissory estoppel is generally considered a substitute for consideration and in most vacation pay and stock option cases, consideration is not at issue. Nonetheless, like the unjust enrichment theory, it offers equitable support for vesting an employee's stock options under certain circumstances.

5. Adhesion Contract

An adhesion contract is a standardized contract that is essentially offered on a "take it or leave it" basis; the party in the weaker bargaining position has no realistic choice as to its terms.\(^{161}\) Recognizing that adhesion contracts are not the result of a traditionally "bargained for" contract, the legal trend is to relieve the parties from the onerous conditions imposed by such contracts.\(^{162}\)

Stock option grants are often thought of only in relationship to executive compensation; however, in many start-up high technology

\(^{160}\) Restatement (Second) of Contracts § 90 (1979).


\(^{162}\) Id.
companies, incentive stock options are given to many employees, especially those with key technical or scientific skills.\textsuperscript{163} Although it can be argued that a high level executive may be sophisticated in contractual matters and should be able to negotiate favorable grant terms,\textsuperscript{164} many key technical or mid-level management employees who receive stock option grants may be presented the stock option grant in a “take it or leave it” manner. These employees may not fully understand the forfeiture implications of the grant terms, or the company may be unwilling to negotiate the terms.\textsuperscript{165} Thus, it is questionable whether a grant that states, “non-vested stock options are forfeited if employment is terminated for any reason” should be enforced for non-executive level employees. In cases where termination is without cause and not under the employee’s control, the harsh effects of such a contract provision could be considered unconscionable for an unsophisticated employee.\textsuperscript{166}

E. Equitable Remedies: Are They Adequate?

The various equitable theories described above offer legal rationales for vesting employee stock options when an employee is involuntarily terminated. However, these theories are, at best, risky prospects for recovery through litigation. Although the theories are legally sound, there is a good chance that a court would hold the laid-off employee to the terms of the stock option agreement. Consequently, since courts have applied equitable remedies in employee benefit cases inconsistently, a fair, consistent solution to the problem is needed.

\textsuperscript{163} See supra note 128.

\textsuperscript{164} It could also be difficult for executives to negotiate stock option agreement terms. See supra note 99.

\textsuperscript{165} See supra note 99 and accompanying text.

\textsuperscript{166} A federal district court hearing a pension benefits case stated that:

[I]t seems harsh to assert that employees assume knowingly the risk of all contingencies which might prevent their recovery of benefits; as if the plan were a negotiated contract agreed upon through arm’s length bargaining. It hardly seems equitable to apply the literal contract language, which may not have been inserted to cover such a situation, to uncritically rule that employees bear the risk of a group termination which may not have been contemplated by the contract . . . . Such a literal enforcement of plan provisions may defeat rather than foster plan purposes. This approach seems particularly unjustifiable where there may be an indication of bad faith or where the doctrine of unjust enrichment is invoked.

V. Proposal

To ensure consistency in the law and to eliminate the basic unfairness of stock option forfeiture caused by involuntary terminations, the California legislature should enact legislation similar to Labor Code section 227.3.\(^{167}\) Such legislation would provide for vesting of employee stock options in a pro rata manner upon without cause, involuntary termination. The text of this new proposed provision would read as follows:

§ 227.4. Pro Rata Vesting of Employee Stock Option Plans
In any termination of employment by an employer for company economic reasons rather than individual performance factors (a "without cause" termination), any non-vested incentive stock options or non-qualified stock options granted to the employee will vest in a pro rata manner upon the effective date of termination.

This new statutory provision is based on drawing an analogy from vacation pay benefits to stock option plans and concludes that the law relating to pro rata vacation pay benefits should also be applicable to stock option grants. Furthermore, the basic principles of equity and fairness support such a provision, regardless of whether stock options are considered deferred compensation or compensation for future services.

A new Labor Code provision would prevent the inequitable situation described in the earlier hypothetical where Ann missed her vesting date by one month and, consequently, forfeited stock options of substantial value. Although Ann’s situation in this comment is purely hypothetical, her circumstances are a reality for some employees, particularly those working for start-up, high technology companies. The proposed law would provide for consistent stock option vesting in layoff situations, set clear standards for companies drafting the terms of stock option agreements, and protect employees from forfeiting their valuable "sweat equity."\(^{168}\)

Pro rata vesting of stock options is the best means to achieve an equitable result among involuntarily terminated employees. For ex-

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168. Kraus, supra note 1, § 13.01. "Sweat equity" is the term commonly used to describe the equity in a start-up company that an employee earns through hard work and long hours. The value of the stock is related to the success of the company, and the success of the company depends on the significant contributions of the employees. "Such equity participation can be particularly significant for employees of a new enterprise in which the potential growth in value—if the company is successful—is likely to be much greater than in a mature company." Kraus, supra note 1, § 13.01.
ample, if at the time of the layoff, employee A is only one month from vesting, but employee B is nine months from vesting, it would be equitable to pro rate the portion of the vesting year so that employee A, who was closer to vesting, would vest a larger portion of his or her shares. In contrast, if vesting were fully accelerated to the next vesting date, both employees would receive complete vesting, even though employee A had rendered more of the required service time.

Pro rata vesting is also a more equitable method than accelerated vesting from the company's perspective. This is because a proportionate value of the employee's services has actually been received by the company. Thus, employees who are not close to reaching their vesting dates would vest only a proportionately small percentage of their stock options. If the vesting were accelerated, the company would be in the position of providing fully vested stock options to those employees who had only worked a small portion of their vesting year.

One important question has not yet been addressed in this comment: whether vesting should be pro rated in cases of involuntary termination "for cause" or voluntary termination by the employee. Although vacation pay is vested under such circumstances, it could be argued that the fundamental incentive and merit nature of stock options requires forfeiture in cases of termination "for cause" and voluntary termination. This proposal takes the position that inequities primarily exist in cases of without cause, involuntary termination and that the new statutory provision proposed should be limited to these circumstances.

For the reasons outlined above, it is proposed that stock options be vested in a pro rata manner upon involuntary, without cause termination. The codification of a pro rata stock option vesting provision solves the problem of forfeiture inequities and provides employees with a fair result upon termination. Consequently, employee dissatisfaction should be minimized and potential litigation prevented.

VI. CONCLUSION

Potential stock option vesting inequities exist when employees are involuntarily terminated without cause. A new statutory provision, comparable to the vacation pay vesting provision of the Califor-
nia Labor Code, should be enacted by the legislature to provide for pro rata vesting of employee stock options. Stock options would then be treated like vacation pay in California; upon termination, laid-off employees would receive a pro rata portion of their stock options. Whether stock options are analyzed as deferred compensation or compensation for future services, there are strong arguments that non-vested stock options should not be forfeited when employees are terminated under circumstances beyond their control. Moreover, equitable theories such as substantial performance, unjust enrichment and frustration of purpose provide solid legal support for adding a pro rata stock option vesting provision to the California Labor Code.

Although a stock option grant is a contract between the employee and the company, the principles of equity and fairness require limits on the extent of forfeiture provisions. These limitations should be codified by the California legislature and provide for pro rata stock option vesting in without cause, involuntary termination. Such a code provision would be fair to both employees and their employers, and result in consistency in the law.

Stock option plans provide employees with an opportunity to benefit directly from the extraordinary appreciation of a start-up company's stock, if the company is successful. Thus, with pro rata vesting, employees who lose their jobs in circumstances beyond their control would not lose this valuable, hard-earned benefit. Appreciated stock options are a direct result of an employee's substantial personal investment in the company's value; this investment of the employee's time, commitment, creativity, and hard work merits protection from the harsh vesting effects of arbitrarily timed company layoffs.

Karen A. Madsen

170. Bouymaster & Frank, supra note 2, § 14.01[1].