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Ontario Court Upholds Forfeiture-On-Resignation Provision of Equity Incentive Plan

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In a decision released on September 12, 2013,[1] the Ontario Superior Court of Justice upheld the enforceability of a provision of an employer's incentive compensation plan pursuant to which unmatured awards are forfeited upon an employee's resignation. The Court held that the provision was a permissible loyalty incentive rather than an unlawful restraint on trade. The case was successfully argued by Hicks Morley lawyers Stephen Gleave and Richelle Pollard.

FACTS

The Plaintiff began his career with TD Bank as an associate and steadily rose through the ranks in the TD Securities Inc. business. Upon attaining the position of Vice President, the Plaintiff commenced participating in the Bank's Long Term Compensation Plan ("LTCP"). In addition to the base salary and annual cash bonus he received, under the LTCP each year the Plaintiff was allocated restricted share units ("RSUs") as part of his overall remuneration. An RSU is a bookkeeping entry, the value of which tracks the value of one share of company stock.

Under the LTCP, RSUs vest, or "mature", at the end of a three year period. If certain conditions are met on the day RSUs mature, the LTCP entitles the employee to a cash payment equal to the value of an equivalent number of company shares based on the share price on the maturity date.

Section 6.5 of the LTCP expressly provides that RSUs are forfeited without notice if the employee resigns from service prior to their maturity date. Each year, the Plaintiff was required to sign a participation agreement acknowledging his award. Pursuant to the participation agreements signed annually by the Plaintiff, he acknowledged having reviewed and understood all of the terms and conditions of the LTCP and agreed to be bound by those terms and conditions, as amended from time to time. Later participation agreements also contained a provision requiring the Plaintiff to initial a box acknowledging that the Bank had drawn his attention to the forfeiture and reduction of award provisions of the LTCP. The Plaintiff acknowledged in his testimony having understood the terms of the LTCP, including the forfeiture-on-resignation provision.

In January 2010, the Plaintiff resigned his employment from the Bank to establish his own hedge fund. At the time his employment ended, the Plaintiff had attained the position of Managing Director. As a result of his resignation, the Plaintiff forfeited the RSUs that were allocated to him in 2007, 2008 and 2009, which had not yet matured on his resignation date. At the time of his resignation, the combined cash value of the unmatured RSUs to the Plaintiff's credit was approximately $1.6 million.

The Plaintiff commenced an action against the Bank claiming entitlement to the value of the RSUs he had forfeited upon resignation. The primary issue at trial was whether Section 6.5 of the LTCP is unenforceable as a restraint of trade.

DECISION

The Court reviewed the law on restraint of trade and the treatment of deferred compensation upon termination of employment, from which it distilled the following two legal principles:

- When examining a clause in an employment contract which forfeits deferred compensation upon resignation, a court must assess whether the clause, on its face, or in practical operation, ties forfeiture to the event of termination itself,

or whether it ties forfeiture to the employee's post-employment conduct.
- If the forfeiture simply results from the cessation of employment, the forfeiture does not operate in restraint of trade. However, even if the forfeiture results simply from the cessation of employment, the terms of the deferred compensation plan must be examined to determine whether or not the employee possessed any vested rights in the forfeited compensation. If the employee forfeits vested compensation, it is necessary to assess whether the forfeiture constitutes an unenforceable penalty clause.

The Court noted that other LTCP provisions specifically addressed the impact of an employee's post-employment conduct on his/her entitlement to the payout of RSUs. For example, the LTCP contained provisions contemplating the forfeiture of RSUs in the event of post-employment solicitation of Bank clients, post-employment solicitation of Bank employees, unauthorized disclosure of confidential Bank information and post-employment competitive activities. The Court did not rule on the enforceability of those provisions of the LTCP.

The Court held that Section 6.5 of the LTCP is a permissible form of loyalty incentive rather than an unlawful restraint on trade because it caused forfeiture upon resignation without regard to the employee's post-employment conduct. In making its ruling, the Court noted that Section 6.5 had not operated to restrict the Plaintiff's activities after his resignation. The Court held that the Bank had a legitimate purpose in tying entitlement to the RSUs to the continuation of service as a means of maintaining employee retention and loyalty; it was irrelevant whether the Bank could have used other means to secure such loyalty.

The Court then examined whether the Plaintiff had a vested right in the unmatured RSUs in order to determine whether it is necessary to consider if the forfeiture-on-resignation provision of the LTCP constituted an unlawful penalty. The Court held that the Plaintiff had no vested rights in the unmatured RSUs. The RSUs were clearly subject to forfeiture at all times up to the maturity date. The redemption value of RSUs is calculated based on the price of a Bank share on the maturity date, not the award date. Communications to LTCP participants and the Bank's proxy circulars consistently referred to RSUs as vesting upon maturity after 3 years. On this basis, the Court held that the Plaintiff had no vested right to a payment in respect of his unmatured RSUs on his resignation date. Since the Court found that the RSUs were not vested, it did not need to consider whether the forfeiture-on-resignation provision of the LTCP was an unlawful penalty.

For completeness, we note that the Court dismissed an argument made by the Plaintiff that he had been constructively dismissed by the Bank when he was promoted to Vice President and became eligible to participate in the LTCP. The Plaintiff argued that he had no choice but to participate in the LTCP, which he characterized as a "take it or leave it" proposition. The Court noted that the Plaintiff was a well-educated, sophisticated businessman who had admitted that he knew the terms of the LTCP. He received significant cash payments each year after he commenced participating in the LTCP. The court held that the Plaintiff freely accepted his promotion to Vice President without protest and signed participation agreements each year in which he acknowledged that any RSUs would be forfeited if he resigned his employment prior to their maturity.

IMPLICATIONS

This case supports the proposition that an employer can, as a permissible loyalty incentive, tie an employee's right to a future payment to being employed on the date the right to receive the payment crystallizes. A forfeiture-on-resignation provision will not be found to be in restraint of trade if the provision neither relates to nor fetters post-employment commercial activities.

The Court's comments further highlight the value of having employees who receive an incentive compensation award sign an agreement acknowledging their understanding of the terms of their compensation plan and award, including the applicable forfeiture/reduction of award provisions. Although failure to do so is not fatal to the enforceability of forfeiture/reduction of award provisions, it is clear that having employees expressly acknowledge their understanding of such provisions can enhance the likelihood that those provisions will be found to be enforceable.

The decision of the Ontario Superior Court of Justice can be accessed here. It should be noted that, at the time of writing, the

decision of the Ontario Superior Court of Justice in this case remained subject to appeal.

Should you have any questions regarding this decision or its implications, please contact your regular Hicks Morley lawyer.

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[1] Levinsky v. The Toronto-Dominion Bank, 2013 ONSC 5657 (CanLII).

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