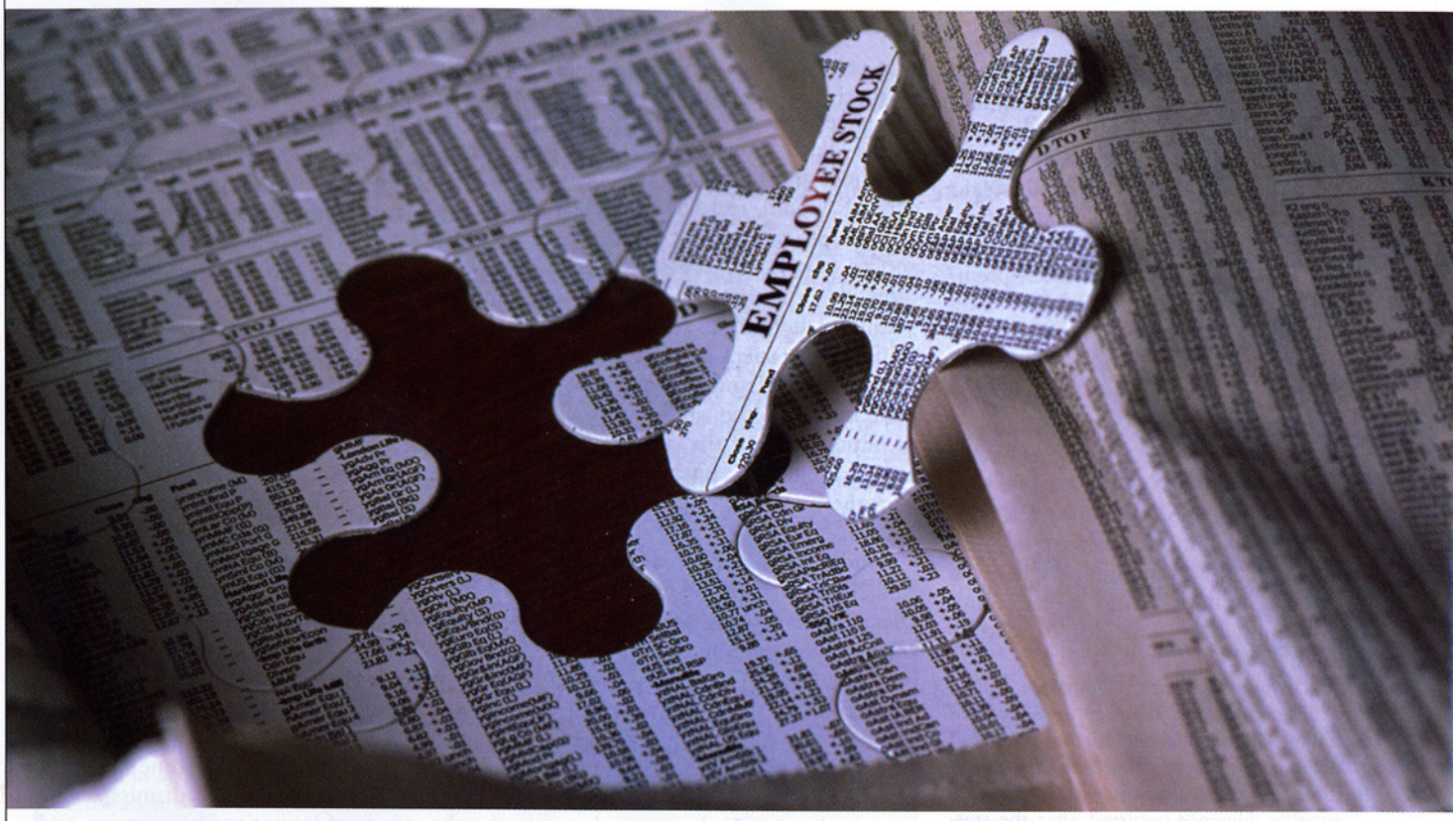

Employee Stock Forfeiture Provisions – A Different Breed of Restrictive Covenant

This article discusses forfeiture-for-competition provisions in employee stock incentive arrangements. The authors posit that they should not be treated as restraints on trade or subjected to a traditional restrictive covenant analysis.

By James V. Garvey and Frederic T. Knape

To the surprise of many companies attempting to enforce noncompete agreements, restrictive covenant provisions are not all treated equally. The type of agreement in which a restrictive covenant is found can impact its enforceability.

Employment agreements, for example, often contain restrictive covenants, as do agreements involving the sale of a business. Illinois law is well settled on the enforceability of restrictive covenants in these types of agreements: the party seeking enforcement must show, among other things, that it has a protectible interest in customers or confidential information and that the covenant is narrowly drawn to protect that interest. The need for this scrutiny arises because restrictive covenants are considered "restraints on trade."[1]

This article addresses another type of arrangement where restrictive covenants can and should be used to protect a company's legitimate business in-

1. See, for example, *Office Mates 5, North Shore, Inc v Hazen*, 234 Ill App 3d 557, 568, 599 NE2d 1072, 1080 (1st D 1992) ("Covenants not to compete are, in effect, restraints on trade and will be carefully scrutinized to ensure that their intended effect is not to prevent competition *per se*").

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terests – forfeiture-for-competition provisions in employee stock incentive arrangements. These provisions typically call for the forfeiture of stock and/or stock options in the event a former employee competes.

No Illinois court to date has addressed the enforceability of a forfeiture provision in a stock incentive arrangement. This article provides guidance in the absence of court interpretation.

We begin the discussion below by examining the general purpose of forfeiture provisions in employee stock incentive arrangements and comparing that to other types of restrictive covenants. Next, we review the law in Illinois and elsewhere governing the treatment of such provisions. We also explain why forfeiture provisions in stock incentive arrangements should not be treated as restraints on trade, or should at least be considered inherently reasonable. Finally, we offer some drafting suggestions on how a company can best position itself in the event the enforceability of a forfeiture provision must be litigated.

Forfeiture provisions in stock incentive arrangements

Employee stock incentive arrangements usually arise where an employer elects to provide certain equity-based incentive opportunities to valued employees. The purpose of these arrangements is to provide chosen employees with an ownership interest in the company as an inducement to contribute to the company's long-term performance.

A representative forfeiture provision in a stock incentive arrangement looks something like this:

> If Employee ceases to be employed by the Company and (1) has accepted or subsequently accepts employment with a "Competitor" of the Company; (2) has obtained or subsequently obtains an "Ownership Interest" in a "Competitor" of the Company; or (3) has engaged in or subsequently engages, either directly or indirectly, in "Competition" with the Company, Employee agrees: (i) that all stock received by Employee pursuant to this Agreement shall be forfeited; (ii) that all stock options (whether vested or unvested) to which Employee is or may become entitled to receive pursuant to this Agreement shall be forfeited; and (iii) that any other rights or entitlements of Employee to stock and/or stock options pursuant to this Agreement shall immediately cease and forever be forfeited.

This provision is different from a traditional restrictive covenant. Unlike a noncompetition or nonsolicitation provision, nothing in this forfeiture provision restricts a former employee from working for a competitor or otherwise competing with the company. It merely calls for a forfeiture of certain stock-related benefits should the employee do so.

The underlying purpose of the forfeiture provision is likewise distinct from that of restrictive covenants. Stock forfeiture provisions are designed to align the interests of the employee with those of the company and to prevent former employees whose interests become adverse to the company from maintaining an ownership interest. In this respect, forfeiture provisions, unlike restrictive covenants, are not designed to prevent wrongful competition or restrain trade. They are designed to maintain ownership with those persons who have a vested interest in the company.

Unlike a noncompetition or nonsolicitation provision, nothing in a stock forfeiture provision restricts a former employee from working for a competitor.

Despite these and other distinctions, it is not clear whether Illinois courts will evaluate the enforceability of a forfeiture-for-competition provision differently than a restrictive covenant.

Treatment of forfeiture provisions by the courts

No Illinois case addresses the enforceability of a forfeiture provision in an employee stock incentive arrangement. There is authority in the seventh circuit (applying Illinois law) and other jurisdictions to support the position that forfeiture-for-competition provisions are not per se restraints against competition and, therefore, are enforceable without regard to any reasonableness or protectible interest analysis.

Johnson. The leading Illinois forfeiture case is *Johnson v Country Life Ins Co.*[2] In *Johnson,* an agent for an insurance company had an employment agreement with a forfeiture provision for renewal commissions (paid in cash) if the agent represented any other insurer in his employer's region. Although it did not preclude the agent from following his trade or accepting other like work for a competitor, the court determined that the forfeiture provision was in restraint of trade.[3] In so ruling, the court stated as follows:

> True, the terminated employee cannot be restrained, i.e., enjoined, from pursuing his occupation nor is he obligated to refrain from so doing, but this is only half the problem....He forfeits his right to commissions which he would have received but for the contractual terms, and this after he has performed all of the services required of him during his relationship with the defendant.[4]

The court then added this:

> Commissions on renewal premiums is a method by which defendant agreed to compensate plaintiff for the services he rendered, and to say that the prospective loss of those commissions does not operate to significantly restrict his right to engage in the pursuit of his occupation following termination of his relationship with the company...is...to divorce the practical application and consequences of the covenant from the hard facts of economic reality.[5]

Given that the provision involved the forfeiture of earned compensation, the court held that the provision was in "restraint of trade," and the validity of the provision was, therefore, "conditioned upon its reasonableness in terms of its effect upon the parties to the contract and the public."[6]

The *Johnson* decision, however, does not provide a general statement of law beyond the facts of that case. In fact, a number of decisions have refused to extend *Johnson* to cases involving, for example, stock option agreements, pension

2. 12 Ill App 3d 158, 300 NE2d 11 (4th D 1973).
3. Id at 164, 300 NE2d at 15.
4. Id.
5. Id.
6. Id; see also *Torrence v Hewitt Asso,* 143 Ill App 3d 520, 525-26, 493 NE2d 74, 76-78 (1st D 1986) (subjecting capital account forfeiture provision in partnership agreement to reasonableness analysis).

plan benefits, and profit sharing plans.[7] There is a strong argument, accordingly, that *Johnson* does not apply to forfeiture of equity-based incentives such as stock.

Tatom. The seventh circuit has come closer. In *Tatom v Ameritech Corp*,[8] an employee executed a stock option agreement that required the forfeiture of all options when and if the employee rendered services of any kind to a business competitive with the employer.

In evaluating the enforceability of this forfeiture provision, the seventh circuit stated that "[t]his is not a case that involves a facially-anti-competitive provision [because] nothing in the agreements at issue actually restricted Tatom's ability to work for Ameritech's competitors."[9] The court added that "[f]ederal cases draw a distinction between provisions that prevent an employee from working for a competitor and those that call for a forfeiture of certain benefits should he do so."[10]

Because Illinois law applied, the court discussed the *Johnson* decision. In distinguishing *Johnson*, the court emphasized that the *Johnson* forfeiture provision, unlike the one in *Tatom*, deprived the employee of earned "compensation" and thus had a "direct and inescapable effect on his livelihood."[11] Citing its earlier decision in *Sarnoff v American Home Prod Corp*,[12] the Court in *Tatom* reiterated the possibility that "an Illinois court might likewise 'pierce the formal wrappings' of a stock option forfeiture provision and deem it the equivalent of an anti-competitive provision."[13] Again referring to *Sarnoff*, the court noted the alternative possibility that "Illinois courts might distinguish between the forfeiture of a 'bonus' like a stock option and 'regular compensation' like wages and the commission, at issue in *Johnson*."[14]

The seventh circuit in *Tatom* did not resolve this issue. The court determined that the stock option forfeiture provision, even if it was a noncompetition provision, was inherently reasonable:[15] "A provision that calls for the forfeiture of a bonus in the form of stock options does not strike us as an unreasonable restraint on competition."[16] The court explained as follows:

> Stock options, in contrast to other types of regular and bonus compensation, give an employee the right to acquire an ownership interest in a company; that interest in turn gives the employee a long-term stake in the company and supplies him an incentive to contribute to the company's performance. [Cite omitted]. A provision calling for the forfeiture of such options in the event that the holder goes to work for a competitor thus serves to keep the option holder's interests aligned with the company's. In this respect, the [stock option] forfeiture provision is not unreasonable.[17]

The policy explanation in *Tatom* supports the position that the sample forfeiture provision above would not be a restraint on competition or, at least, is not an unreasonable restraint. First, as in *Tatom*, the sample provision does not prevent a former employee from competing. Second, unlike in *Johnson*, it is part of a stock incentive arrangement and, as noted in *Tatom*, is designed to keep an employee's efforts aligned with those of the employer.

The Illinois Appellate Court in *Howard Johnson & Co v Feinstein*[18] recognized the same distinction the seventh circuit did in *Tatom*. In *Feinstein*, the court concluded that a restriction in a shareholder agreement on competition did not concern the same subject matter as a noncompetition agreement, despite the reality that "both the non-competition agreements and the shareholder's agreement affect departing shareholders who later compete with Howard Johnson."[19] The court explained that

> [a] reading of the documents establishes that they were designed to serve completely different purposes. The section of the shareholder's agreement pertinent to this appeal provides for a loss of shares in relation to the amount of work performed by departing shareholders who compete with Howard Johnson. As such, it addresses the concern resulting from having [shareholders] whose interests are adverse to Howard Johnson.... The non-competition agreements, on the other hand, serve to protect the company's client base and include remedies sufficient to afford that protection, such as injunctive relief and liquidated damages.[20]

Unfortunately, while *Feinstein* made the same distinction as *Tatom*, the distinction was made in answering a question unrelated to the enforceability of a forfeiture provision. Nevertheless, *Feinstein* does align with the logic of *Tatom* and can be used to support the argument that the forfeiture of stock or similar rights under an employee stock incentive arrangement does not constitute a restraint against competition and should be enforced without engaging in any reasonableness analysis.

Other jurisdictions. This position is supported by well-reasoned decisions from other jurisdictions. In *Johnson v MPR Associates, Inc*,[21] a former employee sought a declaratory judgment that a forfeiture provision in a stock transfer agreement was an unreasonable restraint on trade. The stock transfer agreement provided that the employee would tender his stock to the employer if he became employed by a client of the employer within three years after termina-

Drafters should state that a stock incentive arrangement is designed to give employees a stake that can be withdrawn when they move on and their interests are adverse to the company.

7. See *Tatom v Ameritech Corp*, 305 F3d 737, 744-46 (7th Cir 2002) (questioning scope of *Johnson* in the context of a stock option agreement); *Sarnoff v American Home Products Corp*, 798 F2d 1075, 1080-81 (7th Cir 1986), *rev'd in part on other grounds* (questioning the same in the context of pension plan benefits); see also *Parenti v Wytmar & Co, Inc*, 49 Ill App 3d 860, 868, 364 NE2d 909, 915 (1st D 1977) (commenting in dicta that *Johnson* "merely" decided a forfeiture of commissions issue and did "not deal with the validity of a forfeiture provision in a profit sharing plan").

8. 305 F3d 737 (7th Cir 2002).

9. Id at 744.

10. Id. The seventh circuit expressly distinguishes forfeiture provisions from covenants not to compete. In *Schlumberger Technology Corp v Blaker*, 859 F2d 512, 515 (7th Cir 1988), for example, the court observed that, unlike a covenant not to compete, a forfeiture of benefits clause does not prevent an employee from working in a specific field. Instead, it exacts a certain cost on the employee for exercising his right to compete.

11. *Tatom*, 305 F3d at 744.

12. *Sarnoff* (cited in note 7).

13. *Tatom*, 305 F3d at 745.

14. Id.

15. Id.

16. Id.

17. Id.

18. 241 Ill App 3d 828, 609 NE2d 930 (1st D 1993).

19. Id at 834, 609 NE2d at 933.

20. Id.

21. 894 F Supp 255 (ED Va 1994).

tion of his employment.[22]

On cross-motions for summary judgment, the court held that the restriction was not a restraint on trade.[23] According to the court, the forfeiture provision did not restrict the employee's ability to work for a client. It "merely denied [the employee] the ability to obtain a benefit conferred on select employees if he went to work for a competitor."[24] That denial, according to the court, "does not operate as a restraint on trade."[25]

A similar result was reached in *Grebing v First Natl Bank of Cape Girardeau*.[26] This case involved the enforceability of a forfeiture provision in a noncontributory pension plan if the employee chose to compete after termination of employment.[27]

In evaluating the enforceability of the provision, the court rejected the employee's argument that the forfeiture provision has the same effect as a noncompete provision and should be subject to the same limitations.[28] Instead, the court adopted what it termed the "majority view" that "a forfeiture provision like the one in issue is not a restraint of trade and, thus, the provision does not require the scrutiny of the Court to determine whether it is reasonable."[29] The basis for the court's ruling was the fact that the forfeiture provision did not prohibit the employee from engaging in competitive work but merely denied him the right to participate in the profit sharing plan if he did so.[30]

But decisions from other jurisdictions vary. The court in *Grebing* acknowledged that a "significant minority of jurisdictions have adopted a different position."[31] These courts generally reason that "[a]lthough the agreement is not expressed as a restriction against competition by the employee, its undoubted object and effect is that of a powerful deterrent to the employee's exercise of the right to compete, particularly where… the penalty involved is a substantial sum of money."[32] While this perspective is similar to that of the Illinois Appellate Court in *Johnson*, the forfeiture of earned compensation provision in *Johnson* is markedly different from the sample stock forfeiture provision discussed in this article.

Forfeiture-provision drafting pointers

No one knows how an Illinois court will rule if faced with a forfeiture provision like the sample above. Employers, therefore, should draft forfeiture-for-competition provisions for employee stock incentive arrangements to best position themselves if the provision is challenged.

First, the employer should state in writing that all benefits under the stock incentive arrangement represent an equity-based incentive apart from any wages, commissions and/or other compensation paid to the employee. This step is crucial because, as seen in *Johnson*, Illinois precedent suggests that any restriction that negatively affects earned compensation, even if it does not restrain the employee from working for a competitor, will be treated as a restraint on trade.

Second, the employer should expressly state that the purpose of the stock incentive arrangement is twofold: (1) to align the long-term interests of valued employees with those of the employer by providing an ownership interest in the company; and (2) to prevent former employees whose interest become adverse from maintaining that ownership interest. This clarifies that, unlike restrictive covenants in employment agreements or sale of business contracts, stock forfeiture provisions do not aim to prevent competition or restrain trade.

The employer also may consider using a mechanism other than "forfeiture" in the event of competition. Claw-back provisions, for example, require an employee to return all benefits received under a stock incentive arrangement (e.g., stock dividend payments) in addition to forfeiting stock ownership. At the other end of the continuum are redemption provisions. Unlike claw-back provisions, they entitle the employer to repurchase the stock at a pre-determined price and/or pursuant to a specified formula.

Clearly, an Illinois court would find redemption and forfeiture inherently more reasonable than claw-back, notwithstanding that none of these provisions restrict the former employee's ability to work for a competitor. Moreover, while redemption appears more reasonable than forfeiture, forfeiture is the recommended option because, as is discussed above, forfeiture of an equity-based incentive does not restrain trade and, at the very least, is not an unreasonable restraint on competition.

By drafting in this way, employers can distinguish stock-forfeiture-for-competition provisions from noncompetition and nonsolicitation provisions. They can also clarify the distinction between restraining a former employee's right to compete and the employer's right to prevent former employees with adverse interests from maintaining an interest in the company. ■

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22. Id at 256-57.
23. Id at 257.
24. Id.
25. Id.
26. 613 SW2d 872 (Mo Ct App 1981).
27. Id at 874.
28. Id at 874-75.
29. Id at 875-76 (citing cases).
30. Id; see also *Cinelli v American Home Products Corp*, 785 F2d 264, 266 (10th Cir 1986) (upholding forfeiture provision of deferred compensation plan on basis of distinction between contract provisions that restrain competition and provisions that merely forfeit an economic advantage); *Rochester Corp v Rochester*, 450 F2d 118, 123-24 (4th Cir 1971) (contract language providing for the forfeiture of vested pension plan benefits if employee engaged in competitive employment is valid and enforceable without need to engage in any reasonableness analysis); *Faw, Casson & Co v Everngam*, 616 A2d 426, 436 (Md Ct Spec. App 1993) (language in agreement providing for reduction or partial forfeiture of vested payments owing to withdrawing partner was not "unreasonable restraint of trade").
31. *Grebing*, 613 SW2d at 875.
32. Id, quoting *Holsen v Marshall and Ilsley Bank*, 52 Wis 2d 281, 285, 190 NW2d 189, 191 (1971), quoting *Union Central Life Ins v Balistrieri*, 19 Wis 2d 265, 270, 120 NW2d 126, 129 (1963). See also *Lucente v International Bus Mach Corp*, 262 F Supp 2d 109, 113-14 (SD NY 2003) (noncompetition clause in employee stock purchase agreement that provided for forfeiture of benefits for violation was subject to the same reasonableness test as clause sought to be enforced by enjoining employee from working for a competitor); *Brockley v Lozier Corp*, 241 Neb 449, 488 NW2d 556, 458-460 (Neb 1992) (deferred compensation forfeiture provision treated in the same manner as covenants not to compete); *Pathology Consultants v Gratton*, 343 NW2d 428, 435-36 (Iowa 1984) (forfeiture provision of shareholder's deferred compensation agreement subject to reasonableness analysis).