A Director's Guide to
EXECUTIVE COMPENSATION

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End of Employment = End of Incentive Compensation?

Organizations typically provide their executives with various forms of compensation. The forms of compensation often include salary, annual bonuses, long-term incentives, benefits and perquisites. Over the years, incentive compensation, whether annual bonuses or long-term incentives, has become an increasing portion of, and more integral to, executives' total compensation. Consequently, what happens to that incentive compensation on the cessation of executives' employment is taking on greater significance and leading to more disagreements between the parties as they part ways.

This newsletter reviews some of the recent cases from our appeal courts regarding executives' entitlements to incentive compensation on their departure from their employment or on a change of the control of their employer. These decisions are of significant importance because they are often the final say on these issues, since these cases are rarely heard by our highest court in Canada, the Supreme Court of Canada.

The success of executives in these cases is mixed. The outcomes are based on the specific facts of each of the cases, so caution must be taken when trying to apply the reasoning in these cases to other situations. As further described below, particular caution must be taken in extending the reasoning in *Ocean Nutrition v. Matthews* to other situations, considering the strong and compelling dissenting opinion of the minority of the Nova Scotia Court of Appeal and that leave to appeal the decision to the Supreme Court of Canada is being sought.

Stock options end on termination

In *Carroll v. ATCO Electric Ltd.*, a 2018 decision of the Alberta Court of Appeal, the court denied John Carroll compensation for his lost entitlements under his stock option plan and share appreciate rights program during the period of reasonable notice of termination owed by his employer. John was informed by ATCO Electric in May 2010 that his employment was being

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

This newsletter highlights some of the recent cases decided by our appeal courts in Canada on the rights of executives to their incentive compensation on their departure from their employers or on change of control of their employers. The amounts of incentive compensation at stake in these circumstances can be high. These high states can contribute to more of these cases making their way to appeal courts when the decisions of the trial courts are unsatisfactory to one or all of the parties involved.

The decisions of appeal courts are binding on the lower courts of the province of that appeal court and are persuasive for trial courts outside of that province. As such, is useful to remain current on these cases. Moreover, this is often the highest level of court to hear these cases because they are rarely heard by Canada's highest court, the Supreme Court of Canada — though one of the cases highlighted in this newsletter, *Ocean Nutrition v. Matthews*, has sought leave to appeal to the Supreme Court of Canada.

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— *Nadine Côté LL.B.*

terminated. John had worked for ATCO for 28 years, was nearly 55 years old and most recently had been the Vice-President, Projects and Construction. In being sensitive to John's circumstances, ATCO told John that he could take vacation and a leave of absence until August 31, 2010. John could then 'save face' and 'retire' on September 1, 2010, at which time he would be 55 and eligible for his pension and retirement benefits, including retiree health benefits and his supplemental executive retirement plan. Alternatively, if ACTO terminated his employment with immediate effect, John would have been paid only the commuted value of his pension, presumably at a discount, and he would lose all other retirement benefits. In addition, ACTO offered John lump-sum monthly payments of $15,000 for 28 months from September 2010 to December 2012, for a total of $420,000.

First, John claimed that the period of reasonable notice of termination owed to him was 28 months, taking into consideration that ATCO compensated John for 28 months. The trial judge rejected John's claim and determined that John was entitled to 24 months of reasonable notice of termination, which was confirmed by the appeal court. Correctly, the court noted that the period paid by the employer was not a factor taken into consideration by courts in determining the period of reasonable notice of termination to which employees are entitled.

Second, John claimed that he was entitled to compensation for the lost entitlements under the stock option plan and the share appreciation program during the reasonable notice period. The court rejected this argument, even though courts recognize that, generally, when employers provide pay in lieu of notice of termination, they must compensate the employee for all amounts and benefits to which the employee would have been entitled had the employee worked throughout the period of reasonable notice of termination.

In making its decision to deny John's claim, the court relied upon the express language of the incentive plans. Under the stock option plan, when a plan participant ceased to be an employee, unvested options ceased immediately and vested options ceased within 90 days thereafter, without regard to any statutory or common law notice periods which may otherwise be required for the termination of employment. The share appreciation rights program included nearly identical language. The court reasoned that these clauses contracted out of the common law and had the effect of extinguishing any right of recovery during the period of pay in lieu notice of termination. The court concluded that John had no further rights under the plans after August 31, 2010.

Interestingly, there are two competing legal principles in issue in this case. Under John's employment agreement, the court determined there was an implied obligation to provide reasonable notice of termination of 24 months. Under the stock option plan and share appreciation right program, the court determined that John's entitlements ended when his employment ended, despite the common law obligation to provide reasonable notice of termination. The court upheld the termination terms in the incentive plans with little comment on why the terms in these plans prevailed over the conflicting obligations under employment agreement governing the overall termination obligations. For example, was consideration given for the restrictive terms in new or enhanced incentive arrangements, or did the long-term incentive arrangements replace former annual cash compensation to the detriment of the employees?

Moreover, the court recognized that the termination terms in these incentive plans amounted to a contracting out of the common law implied obligations, which otherwise could have required payment for this loss during the period of reasonable notice of termination. Did these terms also amount to a contracting out of the statutory obligations under employment standards laws to provide notice of termination, which might render them void? If the termination clauses in the incentive plans were void, then presumably the obligations under those plans would continue for the period of reasonable notice of termination.

Courts have recognized that employers who breach their obligation to provide reasonable notice of termination, and instead provide pay in lieu of the required notice, should not be better-off than had they met their obligation to provide the working notice of termination. Had the employer satisfied its obligation to provide reasonable notice of termination, then John's stock options and share appreciation rights would have continued vesting until his termination took effect in December 2012. In this case, the employer was better off breaching its obligation to provide John working notice of termination until December 2012.

Deferred bonus owed after termination

In *Bain v. UBS Securities Canada,* a 2018 decision of the Ontario Court of Appeal, the court awarded David Bain the deferred component of his annual bonus payable after the termination of his employment and beyond the period of reasonable notice of termination. David Bain had worked for UBS as an investment banker and was the Managing Director and Head, Mergers and Acquisitions. In the first eight years of David's employment, his bonus was paid entirely in cash. From 2008 onwards, UBS determined that the amount of bonus in excess of 250,000 Swiss Francs would be paid 40% in cash and 60% in notional UBS AG shares, which would vest over a number of years. In February 2013, David's employment was terminated without cause as a result of the closure of the M&A division of UBS and he was offered 14 months of pay in lieu of notice of termination.

David sued for wrongful dismissal and was awarded 18 months of pay in lieu of notice of termination. The court awarded, among other things, the bonus due to David for 2012 and during the 18-month period of notice of termination. On appeal, UBS argued that David was not entitled to the deferred portion of his 2012 bonus, which was about 60% of the bonus or approximately $1.2 million.

First, UBS argued that David was not entitled to the deferred amounts of his 2012 bonus because they would not be 'received' during the period of notice of termination. The court stated that on the termination of an employee's employment without cause, the employer is liable for damages for the breach of contract, measured by the loss of wages or salary and other benefits that would have been earned during the reasonable notice period. The court rejected UBS's argument and decided that the amounts had been 'earned' by David, even though they would not vest and be received by the end of the reasonable notice period.

Second, UBS argued that the incentive plan itself eliminated David's right to receive the deferred portion of his 2012 bonus. The court stated that the fact awards were granted to "employees" under the plan did not disentitled a terminated employee from having the deferred portion paid as part of a wrongful dismissal award. The court also rejected UBS's reliance on the plan terms that purported to exclude a claim or right of action in respect of UBS's exercise of discretion or "right to claim compensation for any loss in relation to the plan". The court stated: "The claim here is not for compensation for a loss in relation to a plan, or for the improper exercise of discretion. The claim is to have included in this compensation on termination the amounts of the deferred part of his bonus – amounts that pursuant to the plain terms of his employment contract, he would be entitled to expect." The court noted its conclusion was reinforced by other plan terms that provided unvested awards would continue to vest if the employment was terminated due to redundancy.

LTIP ends on termination – really?

In *Ocean Nutrition Canada Ltd. v. Matthews*, a questionable decision of the majority of the Nova Scotia Court of Appeal in 2018, the court denied David Matthews' claim for the payment of his long-term incentive that would have been due in the period of reasonable notice of termination.

David worked for Ocean Nutrition and its predecessors from January 1997 to June 2011. David was 50 years old and most recently held the position of Vice-President. In 2007, Ocean Nutrition introduced a new long-term incentive plan (the "LTIP"). Under the LTIP, 2% of the company's value created on its sale or public offering in excess of $100 million would be distributed among the executives who were plan participants. Ocean Nutrition granted David participation in the plan.

In June 2011, David resigned claiming he had been constructively dismissed. In July 2012, Ocean Nutrition was sold, which triggered the obligations under the LTIP. David sued Ocean Nutrition for constructive dismissal and payment under the LTIP. The court agreed that David had been constructively dismissed, largely due to how David's boss, the Chief Operating Officer ('COO') had treated him in by diminishing his role, undermining his work and avoiding communicating with him. The Court awarded David with 15 months of reasonable notice of termination. However, the majority of the court rejected David's claim for payment under the LTIP of approximately $1.1 million, which would have been due to David during the 15-month period of notice of termination.

The LTIP stated: "ONC shall have no obligation under this Agreement to the Employee unless on the date of a Realization Event [the sale of the company] the Employee is a full-time employee of ONC. For greater certainty, this Agreement shall be of no force or effect if the employee ceases to be an employee of

Ontario Court of Appeal — Osgoode Hall

ONC, regardless of whether the Employee resigns or is terminated, with or without cause… The Long Term Value Creation Bonus Plan … shall not be calculated as part of the Employee's compensation for any purpose, including in connection with the Employee's resignation or in any severance calculation."

Based on the express wording of the LTIP, the majority of the court rejected David's claim. The majority of the court noted that the plan ceased on any termination and that it was not at liberty to include the payment in its calculation of the pay owed in lieu of notice of termination.

The majority of the court considered that while there was tension and disagreement between the COO and David, it found that the COO had not been motivated to get rid of David to deprive him of his LTIP payment. However, what is clear on reading the dissenting decision is that the COO had engaged in a course of conduct to get rid of David, without regard to the impact it would have on him and his entitlements under the LTIP.

The dissenting decision in this case is noteworthy, compelling and warrants strong consideration. The minority of the court found that Ocean Nutrition breached its implied duty that the LTIP and the employment agreement would be performed with honesty and integrity and awarded David damages based on the approximately $1.1 million owed under the LTIP. The minority of the court noted how David was a long-term, loyal employee with specialized knowledge. The minority noted that the former CEO had said David was one of the top 2 to 3 people in the world in his area… and anyone who had gotten any value out of Ocean Nutrition in part owed that to David. The company was basically a start-up in 1997 when David joined and in 2012 it was sold for more than half a billion dollars ($540 million). The minority finds that one rogue manager, the COO who joined the company in 2007, had effectively engineered the dismissal of David over years of deception, lies and manipulation, so that he could not continue working for Ocean Nutrition and participate in the LTIP as he wanted to do. David had even confronted the rogue manager in February 2011 about rumours his employment would be terminated and that the Company was undergoing due diligence for a potential sale, but the rogue manager deflected David and was not honest with him, consistent with his pattern of lies and deceit when dealing with David. Moreover, once David left Ocean Nutrition, he had to relocate his family to Peru to find new work, due to his limited re-employment options. The grossly unfair treatment of David effectively and intentionally forced David out of Ocean Nutrition and deprived David of the opportunity to continue working for the long-term and participate in the LTIP, contrary to the purpose of the plan to retain executives for the long-term. This conduct wholly disaccords with the obligations of honesty and good faith owed by Ocean Nutrition. Consider the converse, if David had been dishonest, deceitful and deceptive to Ocean Nutrition and caused Ocean Nutrition damages as a result thereof, would Ocean Nutrition not have a claim against David? Taking into consideration the gravity of the negative impact on David by the lying and deceptive rogue manager, it is unfortunate that the decision of the minority did not prevail in these circumstances.

This case has been appealed to the Supreme Court of Canada.

Honesty and good faith owed under stock option plan

In *Soraya v. Claron Technology Inc.*, a 2017 decision of the Ontario Court of Appeal, the court granted Reuven Soraya the right to exercise his stock options on the sale of the business of Claron Technology, despite the decision of the Board of Directors that a sale of the business had not occurred and the plan terms that granted the Board final authority under the plan. Claron Technology denied Reuven Soraya the exercise of his 20,000 unvested stock options on its sale of Lexmark. The stock option plan provided that on the sale of all or substantially all of the assets of Claron Technology, the stock options held by employees would immediately vest and be exercisable. The Board of Directors of Claron Technology decided that the sale of Lexmark did not constitute a sale of all or substantially all of the assets of Lexmark, so there was no accelerated vesting of Reuven's stock options. The plan also stated that decisions of the Board under the plan were "final, conclusive and binding" and "not subject to any dispute by any participant".

Reuven claimed, among other things, that the sale of Lexmark constituted a sale of substantially all of the assets of Claron Technology and the Board could not use its discretion under the plan to deny the accelerated vesting of his stock options. The court agreed. The court found that Lexmark represented 87% to 89% of the value of the assets of Claron Technology. This constituted a sale of all or substantially all of the assets of Claron Technology, which triggered the accelerated vesting of Reuven's stock options.

The court also stated that the clause conferring final authority under the plan to the Board did not confer absolute discretion; rather, the discretion had to be exercised honestly and in good faith. The court noted that the only Board members were the co-CEOs who were also the beneficial owners and that they would personally benefit from denying Reuven the right to exercise his stock options. The court decided that the decision to deny Reuven the right to exercise his stock options was not made in good faith. The court ruled against Claron Technology and granted Reuven the benefit of the accelerated vesting of his stock options.

The question we are left with is whether the Board could have relied on its 'conclusive authority' under the plan, if it had acted honestly and in good faith, but merely incorrectly determined that a sale of the business had not occurred. One would expect an employer cannot create binding obligations on itself in its stock option plan, then deny plan participants recourse in reliance on its 'conclusive authority' clause when it determines its obligations incorrectly – right?

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