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Consistent with decisions in other states, the New Jersey Supreme Court rules that a deferred compensation plan with vesting periods and forfeiture provisions does not violate state wage and hour law or public policy.

East Coast Edition

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New Jersey Supreme Court Holds Deferred Compensation Plans with Forfeiture Provisions Lawful

By Stacey D. Adams and Michael T. Grossor

On June 25, 2008, the New Jersey Supreme Court issued its decision in *Rosen v. Smith Barney, Inc.* (A-49-07), holding that deferred compensation plans with vesting periods and forfeiture provisions do not violate New Jersey's wage and hour law or public policy.

Two former Smith Barney, Inc. employees, challenged the company's voluntary deferred compensation stock purchase plan, called the Capital Accumulation Plan (CAP), on behalf of themselves and others similarly situated, alleging that it violated New Jersey's wage and hour law and public policy.

Smith Barney created the CAP as a vehicle for attracting and retaining qualified financial consultants by providing them with the option of participating in a tax-deferred incentive compensation plan. The CAP allowed employees to defer a portion of their earned compensation toward the purchase of stock in Smith Barney's parent company, Citigroup, a publicly traded stock. The primary benefits of participating in the CAP were: (1) the ability to purchase securities in the parent company at a deep discount; and (2) the deferral of income taxes on compensation earned but invested in the CAP. Participation in the CAP was completely voluntary, the terms of the plan were fully disclosed prior to enrollment, and employees were required to sign a written enrollment form prior to participating in the plan. Funds designated for participation in the CAP were initially held for six months, during which time the employee could cancel participation in the plan and receive a full refund of all funds held during the six-month period. At the end of the six-month deferral period, the funds were used to purchase stock. At that point, participants received dividends and were able to exercise their

shareholder voting rights. However, complete stock ownership did not fully vest until after a two-year period. Participants who resigned or were terminated for cause prior to the expiration of the two-year vesting period forfeited all unvested stock. The risk of forfeiture was unambiguously disclosed to participants.

Adopting and expanding upon the reasoning of the Appellate Division, the New Jersey Supreme Court determined that the CAP did not violate New Jersey's wage and hour law or public policy. To the contrary, it found that New Jersey wage and hour law expressly allows such a plan and permits wages to be withheld or diverted for purposes including:

Contributions authorized either in writing by employees, or under a collective bargaining agreement, for payment into company-operated thrift plans; or security option or security purchase plans to buy securities of the employing corporation, an affiliated corporation, or other corporations at market price or less, provided such securities are listed on a stock exchange or are marketable over the counter.¹

The court held that the CAP fully satisfied the requirements of this statutory provision. First, compensation was withheld for payment into securities of the employing corporation. Second, the securities being purchased in connection with the plan were publicly traded. Third, participation was purely voluntary and pursuant to a written agreement. Fourth, the participants' interest in the CAP was immediately defined, since they received all stock dividends and had the ability to exercise shareholder voting rights even prior to the vesting of the stock.

In terms of the forfeiture provision, the court found that, in order for the CAP to qualify as a tax-deferred plan, it had to satisfy the relevant provisions of the Internal Revenue Code (the “Code”). Applicable provisions of the Code mandate that compensation designated for participation in a deferred compensation plan must be subject to a substantial risk of forfeiture in order to be excluded from gross income. Code section 83(c)(1) specifically defines “subject to a substantial risk of forfeiture” as including “if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial service by any individual.” The CAP required participants to remain employed for the two-year vesting period or risk forfeiture (unless the employee was terminated without cause). Thus, the court reasoned, it was the very inclusion of a forfeiture provision that enabled the CAP to qualify for the favorable tax treatment under the Code.

The New Jersey Supreme Court similarly rejected the plaintiffs’ contention that the forfeiture clause operated as a penalty in violation of New Jersey’s public policy. In rejecting this argument, the court distinguished the forfeiture provision from an “unreasonably large” liquidated damages provision, which constitutes an unenforceable penalty. Unlike a liquidated damages clause, which traditionally appears in the context of a breach of contract claim, the forfeiture provision in the CAP was not triggered by a breach of contract. Indeed, plaintiffs did not have any separate contractual agreements preventing them from ending their employment with Smith Barney. The CAP forfeiture clause was, therefore, unrelated to any underlying breach of contract and could not be construed as a penalty, contrary to any public policy concerns.

Similar deferred compensation plans have been upheld by the First Circuit, the Illinois Court of Appeals, the Court of Appeals of Georgia and the Court of Appeals of New York. In addition, the California Supreme Court recently granted review of a state appel-

late court’s decision in *Schachter v. Citigroup, Inc.*, holding that the same CAP at issue in the New Jersey decision did not violate the provisions of California Labor Code sections 201 and 202.

Recommendations:

In light of the supreme court’s decision, New Jersey employers seeking to establish a similar deferred compensation program or amend their current program should keep in mind the following factors to help ensure that the forfeiture provisions will not run afoul of applicable wage and hour laws:

- The contract for participation in the plan should be in writing with all terms fully disclosed to participants prior to enrollment. Most importantly, the forfeiture provisions should be clearly and unambiguously disclosed.
- Participation in the plan should be voluntary.²
- Employees should consent to their participation in the plan in writing on an enrollment form and expressly acknowledge their consent to the forfeiture provisions.
- Participants should be provided some immediate benefits during the vesting period, such as beneficial tax treatment and stock-ownership benefits, such as dividends and voting rights.
- The period of delay for absolute ownership (or the vesting period) should be neither “onerous nor unreasonable.”
- In New Jersey, the stock offered must be in a publicly traded company (as per applicable wage laws). Companies with operations located outside of New Jersey should review relevant state wage and hour laws to ascertain whether a similar limitation applies and tailor their plans accordingly.
- Forfeiture should only apply if the

employee resigns or is terminated by the company for cause. The term “for cause” should be specifically defined in the enrollment agreement.

- To avoid the creation of an unlawful penalty, the operation of the forfeiture clause should not be tied to any separate contractual agreement that would prevent the employee from ending his/her employment.

As with any benefit plan, but especially given the many recent changes to nonqualified deferred compensation plans, it is important that employers consult with an attorney well-versed in establishing such plans and their tax consequences to avoid unexpected tax or ERISA liabilities that may be incurred by the employer, employee, or both, if the plan is not designed correctly.

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¹ N.J.S.A. 34:11-4.4(b)(2).

² The New Jersey Supreme Court emphasized the voluntary nature of the CAP program in concluding that the forfeiture provisions did not violate the state’s wage and hour law. Courts in other jurisdictions have also focused on this factor in upholding such plans. Although not addressed in the *Rosen* decision, it appears that participation in the CAP is mandatory for certain high-level executives. It is not clear whether such mandatory participation would render the forfeiture provisions in the plan unlawful or whether different standards apply to exempt versus non-exempt employees. To ensure that a deferred compensation plan will be upheld, the best strategy is to make it voluntary for all participants.