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Protecting Executive Compensation: Unvested Equity and the Covenant Of Good Faith and Fair Dealing

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Executive compensation comes in many forms. Aside from the basics—salary, bonuses, and fringe benefits— deferred and equity compensation often constitute a considerable piece of an executive's overall compensation package. Deferred and equity compensation come in many forms (stock options, restricted shares, etc.). These equity grants typically vest over time and are tied to certain contingencies, such as remaining employed through a certain date (time-based vesting) and/or meeting certain business objectives (performance-based vesting).

Many executives have employment agreements that provide for severance and/or notice if they are terminated without cause or they leave with good reason. These employment agreements and related equity plans do not necessarily protect unvested deferred or equity compensation. Often, in the context of a without cause termination, what is vested is vested, and what is unvested is forfeited at the time of separation.

However, that is not always the case. As the recent case of case of *Suzuki v. Abiomed, Inc.*, — F. Supp. 3d — (D. Mass. 2017) illustrates, the covenant of good faith a fair dealing may be used to protect an executive unvested performance-based equity awards.

In *Suzuki,* the executive alleged that he was terminated: (1) after performing much of the work necessary to achieve the business objectives to which vesting of his equity was tied; and (2) because he refused to agree to a reduction in compensation.

In its defense, the company alleged, among other things, that it was within its rights to terminate the executive's employment at any time because, under the employment agreement, it had the right to terminate without cause. The company further argued that the performance-based contingencies to which the equity grant was tied had not occurred prior to termination and, in fact, did not occur until fifteen months after the termination. The Court found the company's arguments unpersuasive.

Rather, the United States District Court for the District of Massachusetts (Casper, J) observed (citations and quotations omitted):

> "Under Massachusetts law, every contract implies good faith and fair dealing between the parties to it. …. The implied covenant provides that neither party shall do anything that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract. … This guarantees that the parties remain faithful to the intended and agreed expectations of the parties in their performance."[1]

The Court pointed out that the covenant applies even when the employment is terminable at-will, so as to prevent an employer from being unjustly enriched by depriving an employee of compensation that is, "fairly earned and legitimately expected."

Furthermore, citing to what is often referred to as the "*Gram* doctrine," the Court noted that "a breach of the covenant occurs when an employer terminates an employee without cause, thus "depriv[ing] the employee of clearly identifiable future compensation reflective of the employee's past services."

Here, as the Court observed, the executive alleged that the termination was undertaken *in bad faith* to deprive him of compensation due for his past labor. Distinguishing between performance-based vesting and time-based vesting, the Court held that "while [the executive]'s actual realization of any value of the shares promised him in [his employment agreement], could only take place in the future, those shares served as a 'continuing inducement' for work towards" the performance measures "and they functioned as a part of [his] 'day-to-day compensation' for work performed." Therefore, the Court held, a motion to dismiss cannot be allowed where the employee plausibly alleges the unfair leveraging of a contract term (i.e., the company's right to terminate without cause) to secure undue economic advantage.

BOTTOM LINE FOR DEPARTING EXECUTIVES

First and foremost, negotiate (or re-negotiate) for protection of deferred and equity compensation upon termination. Second, know your rights under contract law. Remember, all employment is contractual in nature, even at-will employment, and every contract carries with it the covenant of good faith and fair dealing. A breach of the covenant of good faith and fair dealing claim may arise from a bad faith termination of employment even if the termination is permitted under the express terms of the employment agreement.

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[1] Although not explicitly addressed by the Court, there is no question but that in Massachusetts the covenant applies to executive employment agreements. *See, e.g., Williams v. B & K Medical Systems, Inc.,* 49 Mass. App. Ct. 563 (2000) (applying the covenant of good faith and fair dealing to written employment contracts, and holding that such covenant requires that neither party rob the other of the fruits of the contract). Indeed, when making decisions regarding termination, including job performance evaluation, an employer must act in "good faith." *See, e.g., Fried v. Singer*, 242 Mass. 527, 531 (1922).