THE OBLIGATION TO PAY INCENTIVE COMPENSATION AS PART OF A SEVERANCE PACKAGE

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BACKGROUND

As anyone who deals with executive compensation will tell you, incentive pay has become a significant element of remuneration. Incentive compensation can take many forms including commissions, bonuses, profit share, stock options, stock ownership, etcetera.

Given the current economic climate and the frenzy of IP/e-Commerce/Internet activity, the ability to attract high calibre personnel will very often be dependent upon how attractive the potential "upside" is, particularly in the area of options on company stock. The publicity given to the "overnight millionaire" employees created in internet start-up companies has created pressure on other employers to offer incentives such as a share of ownership or a share of profits in order to successfully compete for high calibre personnel.

THE ISSUE

The question for our purposes, is what happens when the relationship is terminated without notice? What elements, if any, of the incentive compensation package originally offered to attract the employee (which may equal or exceed salary) is the employer required to pay during the legally required notice period? Put from the opposite perspective, what elements of the compensation package can the employer properly exclude from the severance package?

THE LEGAL STARTING POINT

Unless there is a valid specific agreement to the contrary, a contract of employment can only be terminated (without cause) upon reasonable notice. Ever since *Bardal v The Globe & Mail*, it has been well established that a wrongfully dismissed employee (i.e. terminated without cause and without reasonable notice) is entitled to damages equal to the value of *all forms of remuneration* during the reasonable notice period. This is an important starting point and a basic principle for the analysis that will follow.

THE QUESTION

What would the employee have received had the employer given reasonable notice? Clearly, this would include salary and benefits (or perhaps the value of those benefits). Logically, and to be consistent with *Bardal*, the employee should also be entitled to receive damages on account of the incentive compensation that he or she would have received had the employer complied with its obligation to provide reasonable notice. Keep in mind that a failure to provide reasonable notice constitutes a breach of contract, even if the employer has provided pay in lieu of notice (see *Iacabucci v. WIC Radio Ltd.*). As such, the employee is entitled to be put into the same position as if reasonable notice had been given. As developed more fully below, it is submitted that unless there are compelling contrary arguments from the employer, damages on account of incentive compensation during the notice period will be inevitable.

WHEN WILL INCENTIVE COMPENSATION NOT BE PAYABLE?

Many employers attempt to include language in their agreements with employees excluding liability for incentive compensation following termination. In addition, it is common for employers to designate certain forms of incentive compensation as being “discretionary” and

thus, arguably, subject to the employer's whim to pay or not pay, whether during employment or thereafter. Without such wording it is most likely that the incentive portion of an employee's pay will be payable during the notice period. What, then, if there is exclusionary or discretionary language?

Generally speaking, of course, the parties to a contract are left to contract for themselves and the Court won't interfere. Our Courts have, however, adopted a supervisory responsibility over the employee/employer relationship (see *Matchinger v. HOJ Industries Ltd.*). It is submitted that if the agreement purports to take away a right which the court would otherwise grant, the contractual language must be very clear and unambiguous. It may also have to pass a "fairness test". This is particularly the case where the incentive compensation is significant when compared to salary and where it has been regularly paid over a significant period.

BONUSES

There appear to be three possible scenarios, where claim from bonus will be made following termination namely, (i) dismissal during the period of calculation; (ii) dismissal following the period of calculation but before payment date, and (iii) dismissal before the period of calculation. The employee's argument for payment in situation (ii) is obviously the strongest given contribution to the results. In situation (i), the employee will argue that a pro rata payment based upon the duration of his employment or the degree of accomplishment of bonus objectives during that time is appropriate. Scenario (iii) deals with the claim for the notice period and, if the employee is successful, the entitlement will typically be calculated on the basis of historical averages (*Koor v. Metropolitan Trust Company)*, or by estimating what likely would have

happened (e.g. by comparing him to employees who did receive a bonus during the notice period).

Sometimes the focus of argument will be on whether the bonus is a reward for past service or an incentive for future service with the court more likely to include damages for lost bonus if it finds it was meant as a reward rather than an incentive. (*Sandelson v. Int'l Vintners Ltd.)*.

THE DISCRETIONARY BONUS

Very often a bonus will be designated "discretionary". The employer will thus argue that because the bonus was discretionary during employment, it should not be compelled to pay same during a notice period following dismissal. It is submitted that this argument will and ought to be scrutinized very carefully. Cases have held that where the bonus forms a significant part of the employee's compensation and has been typically paid over a number of years, it will form part of the employee's entitlement during the notice period notwithstanding its "discretionary" label. The thinking appears to be that the more often it is paid the less discretionary it becomes. *(Koor v. Metropolitan Trust Company)*.

Furthermore, if the bonus plan is formula based (as opposed to subjective criteria) or is a "profit share", it is more likely to be construed as being non-discretionary.

Courts have also implied an obligation on the employer to exercise any such discretion bona fide such that if non-terminated employees of similar status received a bonus the "discretion" ought to likewise be exercised in favour of the dismissed employee. (See *Leduc v. Canadian Erectors Ltd.)*.

EMPLOYMENT AT THE TIME OF PAYMENT REQUIREMENT

Quite often a bonus will require the recipient to be actively employed at the time the bonus is paid in order to be eligible for payment. This can have quite harsh results, particularly if the individual has been employed throughout the entire bonus calculation period and can thus legitimately argue that he contributed to the results.

In the case of *Schumacher v. Toronto Dominion Bank*, the court held such a provision to be ineffective. In that case, Madam Justice Kiteley held *"[Mr. Schumacher's] involuntary inability to comply with the condition of the [bonus] ought not to be justification for the Bank in declining the award of bonus as part of Schumacher's damages. ...Where the bonus was promoted as an integral part of the employee's cash compensation, it would be inappropriate and unfair to the employee to be deprived of the bonus by reason of the unilateral action of the employer."* She held that Mr. Schumacher was entitled to bonus both for the period he worked, and for the notice period. This is a case where specific contractual language was held ineffective because it would yield an unfair result. Note, also, the Court's emphasis on the significance of the bonus and the fact that it was promoted as such.

Other judges have dealt with the requirement of being employed on the date of payment by awarding the bonus if the notice period overlaps the payment date. (See *Ferguson v. Kodak Canada*). A similar approach has been taken where the claim is on account, stock options exercisable during the notice period (see discussion, below).

COMMISSIONS

There seems to be little defence to the payment of commissions actually earned to the date of termination (except perhaps where work is yet to be done and the employer will have to

pay others residual commissions to complete the transaction). A clause allowing the employer to withhold commissions actually earned will likely be unenforceable. It is submitted that the proper analysis also calls for commissions to be payable throughout the notice period (based upon historical averages) unless there is clear contractual language to the contrary. (See *Wayne Stephenson Sales Agencies Inc. v. Avrecan International Inc.)* Even if such language exists, the *Employment Standards Act* must be complied with. This *Act* requires wages (including commissions) to be paid during the statutory notice period. Furthermore, it is submitted that a court will be very reluctant to deny an employee such amounts for the common law notice period where they have typically represented a significant portion of income.

STOCK OPTIONS AND SHARE PURCHASE PLANS

Very often stock options or share purchase plans provide for the options to vest over a period of time. Typically, the employee will be entitled to exercise a limited number of options on the anniversary dates of the grant. In addition, particularly if the employer is a private company, the plan will require the employee to sell his shares to the employer on termination. These agreements also usually provide that any unexercised or unvested options will lapse on termination.

The principle that all benefits are exercisable during the reasonable notice period should include the right to exercise any stock options which exist at the date of termination or which would have accrued during the notice period (see *Ryan v. Laidlaw Transportation Ltd.*).

A number of cases have been decided on the basis of the employee's history in exercising options. In other words, if options are typically purchased, then the court will likely find the right to purchase options and thus award damages for the notice period and vice versa. This

makes sense and is similar to the argument advanced with respect to bonus, above, i.e. if bonus is typically paid, it has become a contractual right and should be paid during the notice period.

In the case of *Iacobucci v. WIC Radio Ltd.* the Court of Appeal in British Columbia held that the employee was entitled to the value of options which would have been exercised during an 18 month notice period, and rejected the employer's argument that payment in lieu of notice negated the employee's right to exercise options. The Court of Appeal held that failure to give reasonable notice amounts to a breach of the employment contract even if the employee is given pay in lieu of reasonable notice. As such, Iacobucci was to be put in the same position as if he had worked throughout the notice period.

An exception to the rule in *Ryan* occurs if there is a legally enforceable clause which makes it clear that options will not accrue during the notice period. For example, in the case of *Brock v. Mathews Group* the Ontario Court of Appeal held that the following clause was effective in terminating the options as of the actual date Brock ceased to be employed rather than at the end of the reasonable notice period:

> *"in the event of an employee ceasing to be an employee… the option hereby granted shall forthwith cease and terminate…; provided that where the employee is dismissed by the corporation, the employee shall have 15 days from the date notice of dismissal is given in which to exercise the option…"*

It is submitted, however, that this result will be the exception rather than the rule and that the court will look very carefully at the wording of any clause which purports to deny an employee a significant portion of the compensation to which he or she is otherwise entitled.

In the later case of *Veer v. Dover Corp.*, the Court of Appeal held that to be effective, any clause which purports to terminate the right to exercise options during the reasonable notice period must contain clear language to contradict the general principle. The Court distinguished *Brock* by focussing on the words "date notice of dismissal is given" and concluding that the parties in Brock case intended the actual termination date to be the triggering event.

Interestingly, in *Schumacher*, although the Judge ruled in favour of Mr. Schumacher on account of his right to be paid bonus during the notice period, she ruled against him on his claim to the right to exercise options during the notice period. Mr. Schumacher argued that options lapsing on termination (or within a short time following termination) should be construed as meaning following lawful termination, i.e. after a period of reasonable notice. The Judge did not accept this and, instead, concluded that "on termination" in Schumacher's contract meant actual termination and not lawful termination. One might find this reasoning odd given her willingness to ignore the exclusionary language of the bonus clause because it was unfair. In any event, this decision might well have been different had it been subsequent to the Court of Appeal decision in *Veer*.

Given the Court of Appeal reasoning in *Veer*, it will be up to the employer to draft very clear language if it is to deny the employee such an important benefit during the notice period.

As far as the calculation is concerned, damages for the lost options will generally be assessed as the difference between the option price and market (or fair) value at the date during the notice period on which the court finds that the employee likely would have exercised the option.

If the court finds that the employee was improperly denied the opportunity to acquire shares during the notice period, then it flows that anything that would have come from those shares during the notice period, such as dividends, would likewise be damages to the employee. (See *PCL Construction v. Holmes)***.**

Share purchase plans usually obligate the employee to sell his shares to the company on termination (or gives the employer the right to "call" the shares). The argument on this issue should be identical to that made with respect to the exercise of options, namely, is this obligation to be construed as only accruing after a lawful termination (i.e. after a period of reasonable notice) or as at the date of actual termination? Absent clear and unequivocal wording, the employee should be entitled to damages representing the loss in any capital appreciation which would have accrued on his shares during the notice period.

CONCLUSIONS

1. Incentive compensation will be treated like any other form of remuneration unless there is contractual language to the contrary.

2. In order to be effective, such contractual language must be clear and not offend the *Employment Standards Act*.

3. The greater percentage the incentive is of total compensation, the more objective any criteria and the longer the employee has participated, the less likely exclusionary language will be effective.

4. Even if the language is clear it may be ineffective if clearly unfair (*Schumacher)*.

CITATIONS

1. *Bardal v The Globe & Mail* (1960), 24 DLR (2d) 140 (Ont. H.C.)

2. *Iacobucci v. WIC Radio Ltd.* (1999) 72 BCLR (3d) 234 (BCCA)

3. *Koor v. Metropolitan Trust Company* (1993), 48 CCEL 216 (Ont. Ct. Gen.Div.)

4. *Sandelson v. Int'l Vintners Ltd.* (1987), 18 BCLR (2d) 86 (SC)

5. *Matchinger v. HOJ Industries,* [1992] 1 SCR 986 (SCC)

6. *Leduc Canadian Erectors Ltd.* (1996), 18 CCEL (2d) 216 (Ont. Ct. Gen. Div.)

7. *Schumacher v. Toronto Dominion Bank* (1997), 29 CCEL (2d) 96, (1999), 44 CCEL (2d) 48 (Ont. C.A.)

8. *Ferguson v. Kodak Canada* (1992), 93 CLLC 14,026 (BCSC)

9. *Wayne Stephenson Sales Agencies Inc. v. Avrecan International Inc.* (1998), 45 CCEL (2d) 181 (Ont. C.A.)

10. *Ryan v. Laidlaw Transportation Ltd.* (1995), 26 OR (3d) 97 (Ont. C.A.)

11. *Veer v. Dover Corp.* (1999), 45 CCEL (2d) 183 (Ont. C.A.)

12. *Brock v. Mathews Group Ltd.* (1991), 34 CCEL 50 (Ont.C.A.)

13. *PCL Construction v. Holmes* (1994), 8 CCEL (2d) 192 (Alta. C.A.)