

Global Handcuffs and Claw-Backs: Getting Tough With Cross-Border Loyalty Protections

BY MARK POERIO, ERIKA COLLINS AND CHRISTOPHER WALTER

Tough markets tend to sharpen loyalty issues, as employers compete for an edge that can come from better knowledge, customer contacts or even trade secrets. Luring the best executive talent is the most direct route to an edge. Reflecting employer concern, a 2008 survey by TalentKeepers, Inc. finds that 81 percent of American business executives consider employee retention a top priority -- a staggering jump from the 41 percent in 2007. Smart compensation structures can provide "gold" that encourages long-term loyalty (hence the term golden handcuff). The potential to recoup cash bonuses and stock awards from disloyal or corrupt employees can give rise to a "claw-back" threat for enforcing loyalty and key business protections.

The concept of "global handcuffs" reflects the evolution of personnel-related business protections into widespread cross-border use by multinational companies. These measures can work, and have done so for many. But doing so in an efficient, effective manner takes care -- especially because employers face state law issues within the United States, and country-by-country differences when implementation goes global.

WHAT IS POSSIBLE?

The purest golden handcuff has two distinct attributes that generally reflect the premise "you remain, you gain; you leave, you lose".

The Carrot. A golden handcuff structure essentially involves a shift to, or increased emphasis on, cash and stock awards having a long-term orientation. This means that executives build value over their years of employment, but collect it on a deferred basis that is normally tied to termination of employment. During the period of benefit build-up, the value of stock awards will depend on the employer's success -- thereby encouraging sustained executive performance. The same is possible for cash bonuses because they may be redirected into deferred compensation whose value rises -- or falls -- based on a corporate performance measure such as revenue or profit growth. Alternatively, cash bonuses could be converted into restricted stock or units (or deferred stock units, aka **DSUs**, which represent a presently vested right to receive shares at some future date). In all cases, the accumulation of deferred compensation ideally ties an employee's self-interest to the employer's

long-term success. This is the carrot for encouraging employee loyalty and solid performance.

The Stick. There is a stick to any golden handcuff, and it comes in the form of a forfeiture or claw-back risk. Both of these risks normally apply not only during an executive's employment period but also post-employment -- commonly for one year. Forfeiture may result from poor corporate performance, as well as from an executive's disloyal conduct (such as violating a non-competition or non-solicitation commitment). More and more employers are tying forfeiture triggers to significant yet discrete business risks. For example, it is essentially a no-brainer for employers to trigger forfeitures and claw-backs when executive fraud or misconduct causes a financial restatement. The event is a business disaster, and it should be the same for a wrongdoing executive.

ENFORCING GLOBAL HANDCUFFS

In an ideal world, multinational companies would be able with confidence to choose one set of laws to govern the mechanics of the golden handcuffs. Unfortunately, however, enforcement tends to happen at a local level, where laws governing restraint of trade, and underlying public policy, are mandatory. Implementing golden handcuffs globally therefore becomes a challenging task, requiring consideration of what should be presumed to be vastly different laws. For example, in Chile, a non-competition clause will always be unenforceable because of a constitutional rights afforded to employees. In the U.K., a recent decision mentioned public policy concerns with forfeiture-for-competition provisions, yet left the door open for enforcement (*Duarte v. Black & Decker, 2007, EHCW 2720*). In France and China, the employer must pay consideration to affected executives throughout the period of any post-employment non-competition agreement. More complicating, the exact amount may vary, in

China, based on the province in which the company or the employee is located.

In many other countries, the courts will enforce the forfeiture of future benefits so long as the conditions are agreed to up front, when the grant or payment occurs. For example, an employer's award of DSUs could require the employee's compliance with post-employment loyalty provisions by stating that the DSUs vest during the post-employment period and cease vesting if a breach occurs. Courts in Germany, Japan and the U.K. are likely to enforce forfeitures of this type. In the U.S., the pool is even murkier. Employers face design choices under which some golden handcuff plans may be subject to varying state laws (including those of California, which expressly invalidate most non-competition agreements), while other golden handcuff arrangements will be potentially enforceable through a body of federal common law that preempts state non-competition laws.

Another layer of complication frequently arises with respect to the jurisdiction in which disputes with executives should be decided. In the EU, disputes relating to contracts of employment (including cash and stock award plans) have to be determined in the country in which the employee is domiciled, even if a contract or award specifically states otherwise and is with a foreign holding company (rather than the local employer entity). As indicated above, this results in the mandatory application of local laws and public policy. For example, recent court decisions in a number of EU countries, including France and Germany, require the application of their local law to certain kinds of employment-related agreements that may include golden handcuff provisions. In Belgium, golden handcuffs will not be enforced unless they are written in the appropriate language (which may be French, German, Dutch or Flemish, depending on the region of Belgium in which the employee works) and comport with Belgian legal principles. Conversely, the U.K.'s Duarte

decision (noted above) confirms that U.K. courts will respect the parties' choice of law, provided the relevant provisions are consistent with U.K. public policy concerning restraint of trade.

Other twists affecting global handcuffs relate to the types of awards being made. Stock options and restricted stock will generally be unlawful in China, unless they are settled solely in cash. The same is true for DSUs and RSUs (restricted share units). And in Germany, restricted stock may be awarded, but immediate taxation could result -- while an RSU grant would defer taxation until vesting.

Finally, country-specific factors will affect the scope of any claw-back or forfeiture condition that employers add to their cash or stock award practices. For example, there is precedent in the China, Japan, and the U.S for enforcing a provision in a new award that extends a forfeiture condition to all past awards -- the premise being that the new award is consideration for the modification of contract rights in past awards. Although employers may find this type of broad-based modification appealing, executives often perceive it as heavy handed, and even wrongfully retroactive in reaching vested interests. There is judicial precedent in France, Germany, and the U.K .that could support this view (as an unreasonable penalty provision, or as an impermissible forfeiture of vested benefits, in violation of local public policy).

LATENT DISCRIMINATION?

Cash and stock award practices that satisfy U.S. discrimination laws may nevertheless run afoul of laws in other countries. Problems may arise under local employment laws if employers draw distinctions between full-time versus part-time employees, as well as on the basis of age. For instance, in the EU, employers may not discriminate against employees based on their part-time or fixed-term employment status. So, for example,

whatever benefits employers provide to full-time employees must also be provided to part-time employees on a pro rata basis. This is in contrast to the U.S. or China where employers are generally free to choose which employees will be eligible for which benefits.

If age is included as a factor that affects benefits under a golden handcuff provision or an award agreement, employers should be aware of the nuances of local anti-age-discrimination rules. In the U.S., federal laws prohibit discrimination against older workers (40 years or older) in granting employee benefits unless reductions in benefits are justified by a significant cost consideration, but reverse age discrimination (favoring the old over the young) is permissible. (*General Dynamics v. Cline*, 540 U.S. 581 (2004)) In contrast, in the EU, age discrimination laws prohibit providing benefits that are age discriminatory unless there is an objective justification, and recent case law confirms that the laws apply to all employees -- thereby providing younger workers with recourse when employers favor older ones. China lacks express anti-age-discrimination laws, but the general equal treatment principle under Chinese employment law may serve as the basis for an employee's age discrimination suit.

Finally, employers may encounter award issues when the employment-related provisions of cash or stock awards reflect company policies, such as termination of vesting if an employee takes more than a specified amount of leave in a given period of time. Forfeitures tied to maternity leave, for example, could give rise to gender discrimination claims. In the U.S., this is not a problem because the law only requires employees on leave for pregnancy-related conditions to be treated the same as other temporarily disabled employees. However, in the U.K. and the EU, a failure to pay a discretionary loyalty bonus to employees on maternity leave was held to be discriminatory under the law. (*Gus Home Shopping Ltd v. Green McLaughlin*, [2001] IRLR 75 EAT). In

China, employers may not reduce benefits during a female employee's maternity leave, so forfeiting bonus or stock awards due to maternity leave would likely be illegal gender discrimination

CONCLUSION

The global use of golden handcuff and claw-back protections should not be taken as a

guarantee of enforceability -- or even legality. Nevertheless, when thoughtfully constructed, they have the potential to protect vital business interests, both by encouraging better employee performance and by discouraging competition and other disloyal behavior after an employee's termination of employment. These protections merely call for precautions before the occurrence of awards -- and avoidable employment law violations.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Washington DC

Mark Poerio
202-551-1780
markpoerio@paulhastings.com

Kristin Chapman
202-551-1743
kristinchapman@paulhastings.com

New York

Erika Collins
212-318-6789
erikacollins@paulhastings.com

Marjorie Culver
212-318-6650
marjorieculver@paulhastings.com

London

Christopher Walter
44-20-3023-5129
christopherwalter@paulhastings.com

Chris Bracebridge
44-20-3023-5138
chrisbracebridge@paulhastings.com

Paris

Deborah Sankowicz
33-1-42-99-06-79
deborahsankowicz@paulhastings.com

Beijing

Monica Debiak
86-10-8567-5308
monicadebiak@paulhastings.com

Hong Kong

Michael Downey
852-2867-1283
michaeldowney@paulhastings.com

Shanghai

Lesli Ligorner
86-21-6103-2968
lesliligorner@paulhastings.com

Charles Wu
86-21-6170-6380
charleswu@paulhastings.com

This article is reprinted with permission from the September 18th issue of Law.com © 2008 ALM Properties, Inc.

18 Offices Worldwide Paul, Hastings, Janofsky & Walker LLP www.paulhastings.com

StayCurrent is published solely for the interests of friends and clients of Paul, Hastings, Janofsky & Walker LLP and should in no way be relied upon or construed as legal advice. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2008 Paul, Hastings, Janofsky & Walker LLP.

IRS Circular 230 Disclosure: As required by U.S. Treasury Regulations governing tax practice, you are hereby advised that any written tax advice contained herein or attached was not written or intended to be used (and cannot be used) by any taxpayer for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code.