

"The company prevailed because . . . the employment agreement . . . provide[d] that the grant was subject to . . . the [company's] Stock Option Plans and . . . form of stock option agreement . . ."

## OPTION EXERCISE FOLLOWING TERMINATION OF EMPLOYMENT: EMPLOYMENT AGREEMENT WHICH CONFLICTS WITH OPTION AGREEMENT

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Conflicts concerning the period for exercising stock options are very common, particularly following a contentious termination of employment. A recent case suggests a couple of tips for helping employers prevail in those disputes. The case is *Donaldson v. Digital General System*, 168 S.W.3d 909 (Tex. App. 2005), a state court decision from the Court of Appeals of Texas.

In *Donaldson*, the former president of a company brought suit against his former employer for refusing to honor the president's request to exercise stock options after he left the company. The president argued that he had one year following termination of employment to exercise, while the company maintained that he had only 30 days to do so. The company prevailed in the litigation, even though the president's employment agreement seemed to give the president a full year to exercise. In particular, under the employment agreement the term of the option was ten years, "subject to earlier expiration one year following the termination of [the president's] Employment or other service with the Company."

The company prevailed because although the provision of the employment agreement dealing with stock options said the president would have one year to exercise following termination of employment, it went on to provide that the grant was subject to "the other terms and conditions set forth in one of the [company's] Stock Option Plans and in the company's standard form of stock option agreement . . . ." The referenced option agreement provided for only a 30 day exercise period following termination of employment. In addition, both the employment agreement and the option agreement were subject to the company's stock option plan, which also provided for a 30 day post-termination period for exercise (unless a longer period was determined by the company's board of directors at the time of grant).

In determining which of the conflicting provisions applied – the one-year exercise period in the body of the employment agreement, or the 30-day period in the option agreement and plan document – the appeals court concluded that the employment contract was ambiguous and deferred to the trial court's finding that the parties intended a 30-day exercise period. The trial court had accepted testimony from the parties concerning their discussions and negotiations about the employment agreement. The testimony of the chairman of the board was equivocal, but the court noted that the president was well versed in the details of the plan, had received and exercised prior grants, and acknowledged that the board was authorized to issue the options only under the approved plan, which

"[The executive's] failure to make written demand [to exercise] was important because the option agreement provided that the options were exercisable by written notice, . . ."

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set forth the 30-day post-termination exercise period. The court was not persuaded by the president's argument that the employment agreement unambiguously provided a one-year period for exercise. The president had argued that when the employment agreement referred to "other" terms and conditions from the option agreement and option plan, these terms did not include the time limit for exercise since that term had been explicitly set forth in the employment agreement (as one year) and, therefore, could not be an "other" term.

Interestingly, the court also concluded that even if the president had a right to exercise his options for a full year following termination, he had failed to timely exercise because he had not made written demand for exercise within that one year period. Instead of making written demand, the president had called the company's employee in charge of administering stock options about three months following his termination to inquire about exercising his options. The employee testified that she told the president her records showed he had no active stock options. She then referred the matter to the company's chief financial officer, who spoke to the president about the 30-day time limitation.

This failure to make written demand was important because the option agreement provided that the options were "exercisable by written notice," and set forth the details required to be in such a notice. The president argued that when the employee responsible for the stock option program told him he had no active options on her books, this constituted a breach of the company's obligation to honor his options, and thereby excused him from any further obligation to submit notice. The court rejected this argument, concluding that the requirement to give written notice for exercise was not excused by the company's employees telling the president he had no active options available for exercise.

**Lessons.** The *Donaldson* case teaches two lessons. The first is that the common practice of including in employment agreements a statement that any stock option awards will be subject to the terms of the company's stock option plan and the option award agreement, and that the terms of the plan and award will prevail in the event of conflict with the employment agreement, is a good one.

The second lesson is that there can be value in including in a stock option plan and award agreement a requirement that options be exercised in writing and, perhaps, in including a requirement that exercise be made by use of a particular form approved by the board's compensation committee (or other committee administering the plan). Requiring the use of a particular form to exercise, or requiring that particular information be included in any written notice to exercise, may reduce uncertainty as to when an executive has properly and timely exercised.

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