

"The former employee argued that the company had no right to bar her from exercising her options during the blackout period."

**STOCK OPTIONS:  
BLACKOUT NECESSARY UNDER SECURITIES LAWS**

by  
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A federal appeals court recently rejected a former employee's complaints about her employer's decision to suspend her right to exercise stock options when the company found it necessary to retract its financial statements. In *In re Cendant Corp. Securities Litigation*, the federal appeals court for the Third Circuit, in an unpublished decision, addressed both (a) the company's decision to impose a blackout on the exercise of options, and (b) its compensation committee's decision to later extend the period for exercise to compensate for the blackout.

The lawsuit was brought by an employee who resigned and, as a result, faced a four month deadline for exercising her options. Prior to the former employee making a request to exercise, the company learned of problems with its accounting practices and retracted its financial statements from the SEC. The company concluded that federal law did not allow it to issue additional stock until it had filed new financials. For that reason, the company imposed a temporary blackout on the exercise of employee stock options and informed the former employee that it would not release shares of stock in response to her exercise request. Once the blackout was lifted, the former employee was allowed an additional number of days to exercise her options equal to the number of days she lost during the blackout period. Although the former employee took advantage of this extended opportunity to exercise, she earned substantially less than she would have had she been able to acquire and sell her stock during the blackout period.

The former employee argued that the company had no right to bar her from exercising her options during the blackout period. She noted that although the terms of the option plan allowed the company to postpone *issuing certificates* as necessary or desirable to comply with the requirements of securities laws, and allowed the compensation committee to impose restrictions on the *resale* of shares, it did not explicitly authorize the company or committee to impose a prohibition on exercise. The court rather easily rejected this argument that the company breached its contract, saying that what the company did was "practically indistinguishable" from what it was clearly authorized to do – that is, to refuse to issue certificates upon exercise and to restrict the resale of shares. In addition, the court observed that the company's refusal to allow the former employee to exercise was better for the former employee than allowing her to exercise, take her money, but not give her the shares until later. Notably, the court seemed to suggest that even if there had been no plan provision authorizing the withholding of shares, the court would have implied such a right. In that regard, the court said "[i]t is axiomatic that a court may refuse to enforce a contract that violates public policy." Presumably, requiring a company to

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violate federal securities laws in order to honor the terms of an option agreement would violate public policy.

For reasons that are not apparent from the court's decision, the former employee also argued that the company had no right to extend her period for exercise following the blackout period. The court rejected this argument for a variety of reasons. For one thing, the court said, the extension was a proper exercise of the compensation committee's power under the plan "to make all other determinations necessary or advisable for administering the Plan." The court also rejected the former employee's claim because even were there a breach of contract, the former employee would have suffered no damage. That is because even if the company had permitted the former employee to exercise during the blackout period, it would have prevented her from selling the stock she acquired for the balance of the blackout period. The former employee therefore could not have captured the current value of the shares as of the date she wanted to exercise. And, of course, had the company refused to extend the exercise period, the former employee would certainly have been in no better position than under the course of action taken by the company, which provided her with an extended period of time in which to exercise.

**Lessons.** The *Cendant* decision is a reminder of the value of including in a stock option plan and any resulting option awards an express provision permitting the plan's administrative committee (a) to suspend the right to exercise during any blackout period that is necessary or desirable to comply with requirements of the securities laws (and, perhaps, other laws), and (b) to extend the period for exercise by an equal period of time. Although the result may be the same where, as in *Cendant*, a plan simply authorizes the company to postpone issuing certificates without expressly prohibiting exercise, the inclusion of an express prohibition on exercise may head off litigation.

Where a plan fails to include an express provision prohibiting exercise, the Third Circuit's rationale in *Cendant* – that a court may refuse to enforce the terms of an option agreement (or other contract) that would otherwise require the company to violate securities or other federal laws – may provide an implied right to prohibit exercise during a blackout period required under the securities laws (or other federal, and perhaps state, laws). Similarly, where a plan, such as that in *Cendant*, fails to provide for a post-blackout extension of the exercise period, the court's argument in *Cendant* that such an extension was the proper exercise of the plan administrative committee's power "to make all other determinations necessary or advisable for administering the Plan" may prove helpful, although one should note that the court's decision was unpublished and, therefore, not precedential.

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