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"How would you feel if your stock options vanished when the subsidiary you worked for was absorbed into its parent?"

DISAPPEARING OPTIONS: ISSUER ABSORBED INTO PARENT

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How would you feel if your stock options vanished when the subsidiary you worked for was absorbed into its parent? Well, probably a bit like the plaintiff in *Kingsland v. Xerox Corp*., 2011 U.S. Dist. LEXIS 139214 (W.D. N.Y. 2011), who filed suit saying that just wasn't right. The court, though, said the loss of options was legal.

The plaintiff asserted that while he was employed by Xerox as a Senior Vice President, Xerox offered him the opportunity to join XES, a new Xerox subsidiary. The executive would receive similar pay and benefits at XES, with one notable difference. The difference was that Xerox retirement benefits included an annual employer contribution of up to 8.25 percent of the executive's salary, while the XES offer included no such employer contribution. The XES offer did, though, include stock options in XES. The executive said he and others were told the options might be profitable if and when an initial public offering of the subsidiary's stock were to take place.

The executive worked for XES for about five years. But the subsidiary did not thrive. Although the executive alleged that Xerox received a cash purchase offer for XES in the amount of $100 million, Xerox did not sell the subsidiary. It instead chose to re-absorb it into Xerox. The executive was terminated during that process, as apparently were a number of other employees. The executive said he asked Xerox to reconsider its decision to re-absorb the subsidiary, and asked that it consider offering affected employees reinstatement into Xerox's retirement plan, as well as replacement of XES stock options with Xerox stock options. Xerox declined to do so.

The executive, in exchange for salary continuance payments and other benefits, signed a release of claims in favor of both Xerox and its former subsidiary, XES. This did not, however, stop the executive from filing suit, claiming that only after signing the release did he learn that Xerox received the cash purchase offer for XES, despite its representations to the contrary. The executive said he would not have signed the release had he known about that offer, and asserted that Xerox breached its contract with the executive and was unjustly enriched by its actions.

The court rejected the executive's arguments on two grounds. First, the executive's claims were simply not viable. Xerox could do what it wanted with its subsidiary. It never promised to preserve the value of the stock options for the subsidiary's employees by favoring a sale of the subsidiary over its re-assimilation. Second, the release the executive signed prohibited him from suing.

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As to the executive's claims that Xerox violated a contractual obligation, the court said the executive made no credible claim that Xerox had any contractual obligation to solicit or accept purchase offers for the subsidiary or otherwise preserve the value of the subsidiary's employees' stock options. As to unjust enrichment, there was no allegation that Xerox profited at the XES employees' expense in re-absorbing the subsidiary. In fact, the executive alleged that Xerox spent an additional $50 to $75 million to close the subsidiary, rather than sell it for the alleged $100 million offer.

The executive also asserted that Xerox violated the covenant of good faith and fair dealing implied in all contracts under New York law. But that covenant can impose an obligation on a party only where the implied obligation is consistent with the other terms of the contract. Any implied obligation of Xerox to sell the subsidiary would not have been consistent with its contracted obligations because the stock options were offered merely as an opportunity for employees to profit if the subsidiary's value were to increase. The stock option plan documents did not impose or imply any duty or promise on the part of Xerox to preserve the value of the options for the benefit of the subsidiary's employees by favoring a sale of the subsidiary over its re-assimilation. The company's business decision to re-absorb the subsidiary could not, therefore, be characterized as a breach of the covenant of good faith and fair dealing.

As noted, the court also rejected the executive's claims because the executive had signed a release, including a release of claims the executive did not know about at the time he signed. The executive contended that the release was void because the executive was induced to execute the release either by economic pressure or by reason of fraud. As to the contention that the executive was subjected to economic pressure to sign the release, the court said this was an insufficient ground to void the release because the executive retained the consideration he received in exchange for the release. The court noted other decisions holding that once an employee is aware of grounds for voiding a release, the employee's subsequent decision to keep what he or she received in exchange for the release operates to ratify the release.

With respect to the executive's claim that the release was void because Xerox had fraudulently induced him into signing it by falsely claiming that Xerox was unable to sell the subsidiary, the court said a claim of fraudulent inducement requires, among other things, that the plaintiff have been damaged by reason of the false representation. The court said the executive was not damaged by any false representation that the company had been unable to sell the subsidiary. That is because the executive's claim was for the devaluation of his stock options, and that devaluation was a consequence not of any false statement by Xerox but instead by Xerox's decision to re-absorb the subsidiary. Further, to the extent the executive claimed he was damaged because he would not have signed the release but for the alleged misrepresentation, the court said the executive was not damaged because the executive had no valid claim to pursue against Xerox.

Lesson. The lesson, perhaps more for executives than for employers, is to pay careful attention not only to the provisions of stock options relating to the sale of the employer, but also to what happens if the employer is merged into a parent and out of existence. Where a parent is extinguishing an unprofitable subsidiary, an executive may, of course, have a fairly weak hand in arguing for compensation since the executive's options will likely be underwater. Nonetheless, an executive might argue that underwater options still have value, and hope to receive substitute options in the parent's stock. The executive's position might be that the parent pulled the trigger too quickly on the re-absorption, and that the subsidiary would eventually have performed. For employers, the lesson is the other side of the coin – there should be no promise of compensation in exchange for options in a failed subsidiary.

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