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JULY 26, 2010 VOLUME 6, NUMBER 4

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OPTION VESTING ON CHANGE IN CONTROL: TIMELY CONSTRUCTIVE TERMINATION NOTICE

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Matters are often in flux following a change in control. For some executives, it may be unclear for a period of time precisely what employment, if any, will be available to them. This uncertainty is, of course, important for executives in its own right. But it can be doubly unsettling for an executive who must give timely notice of a constructive termination in order to receive change in control benefits. The executive may wonder whether it is better to give notice early, to ensure that notice is timely, or instead wait for a time to see how things shake out, hoping that refraining from giving notice will improve the executive's odds of securing an appropriate position going forward.

The federal Court of Appeals for the Ninth Circuit recently held that an executive was not required to give notice of constructive termination until the executive had sufficient detail about a promised position to determine whether that position would involve a substantial reduction in responsibilities. The case is *Sluimer v. Verity, Inc.*, 49 EBC 1238 (9th Cir. 2010).

The executive's employer had adopted a change in control plan in anticipation of a possible acquisition. That plan provided for accelerated stock option vesting, as well as continued medical benefits and a cash severance payment, under a double trigger arrangement. Specifically, an executive could become eligible for benefits following a change in control either as a consequence of an involuntary termination without cause, or voluntary termination after "a substantial reduction in the [executive's] duties or responsibilities." It was this latter "constructive termination" provision that was at issue.

The court was required first to determine whether there had, in fact, been a constructive termination, before determining whether the participant had given timely notice that he believed a constructive termination had occurred. This latter question was a bit tricky because the circumstances relating to the executive's future employment with the company changed with time. In particular, following the company's acquisition, the executive was told that he was at risk of being terminated unless a suitable alternative position could be identified for him. On January 5, 2006 – and the dates are important – the acquiring company's chief operating officer contacted the executive to inform him that there would likely not be a similar position available for him. Consistent with this gloomy news, the executive's access to his company e-mail address was terminated just a few hours later. But the executive continued to receive his base salary for the next few months. So at least there was that. And, in fact, on March 23, 2006, the COO sent the executive a letter alerting him to an alternative position at an entity controlled by the acquirer. But this letter did not contain many details about the new position. Over the next month or so, the

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executive attempted to learn more about the alternative position, to determine whether it was comparable to his former position.

The timing of these events was at least arguably critical because the plan required that a participant relying on the constructive termination provision of the plan provide the company with written notice that the participant believed there had been a constructive termination. This notice was required to be provided within three months of the date of the constructive termination. The company then had 15 days after receipt of the notice to cure the conduct giving rise to the constructive termination.

Note that almost three months passed between the date the COO told the executive there would likely be no similar position available for him and the date of the letter from the COO alerting the executive to an alternative position. The executive took some time to learn more about the position, to determine whether it was comparable to his prior position. The executive then gave notice of the constructive termination via an e-mail on April 25, 2006, and a later letter sent by e-mail and "registered delivery" on July 13, 2006.

Importantly, the court concluded that the event triggering the executive's notice requirement could not have occurred until at least April 18, 2006, when the executive learned, for the first time, what the alternative position would entail. The court said it would have been impossible for the executive to notify the company that he believed a constructive termination had occurred until he had been provided with sufficient detail about the alternative position to determine whether it would result in "a substantial reduction in [his] duties or responsibilities." As a consequence, the April 25 and July 13 communications from the executive to the company constituted timely notice of the constructive termination.

Before reaching the question of whether notice was timely, the court, of course, had to determine whether there had been a constructive termination. The court concluded that the former executive did, in fact, voluntarily terminate after a "substantial reduction in [his] duties or responsibilities," and that this constituted a constructive termination under the plan's double trigger provision. The executive, prior to the change in control, had been a Senior Vice President for Operations in Europe, the Middle East, Africa, and Asia, managing over 100 employees including 10 country managers. He was responsible for overseeing operations generating approximately $50 million in revenue, reported directly to the company's president and CEO, and had responsibilities extended to various facets of the company's business, including sales, marketing, finance, administration, and technical operations. In contrast, the new position the executive was offered would have put him in charge of roughly $5 million in revenue, and only 15 employees. The new position would also have involved only sales, and would have required that the executive report to a general manager rather than to the CEO.

In addition to arguing that the executive had not been constructively terminated and had not given timely notice, the company argued that the executive was not entitled to benefits because he had failed to execute a general waiver and release, and had failed to confirm in writing that he would be subject to the company's confidentiality agreement and noncompete agreement, both of which were conditions to the receipt of benefits under the plan. The court held that the executive need not satisfy these conditions unless and until he was to be awarded benefits, which had not previously occurred. That is, the executive was not required to execute the waiver and release, confidentiality agreement, and noncompete agreement in advance. He was only required to do so once a determination had been made that he was entitled to receive benefits.

Lesson. Determining the date on which a constructive termination has occurred can be difficult. There is simply no way around this given the inherent

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uncertainty following a change in control. It would, however, be helpful for the purpose of triggering the commencement date for any constructive termination notice requirement for an executive to be given as clear a picture of his or her future responsibilities in as compact a timeframe as possible.

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Note: This article has been published in the *NASPP Advisor*, a publication of the National Association of Stock Plan Professionals (NASPP).