

No Restraint: Ontario Superior Court Confirms Deferred Compensation Can Be Forfeited On Resignation



As an incentive to encourage employee loyalty, many employers offer deferred compensation to employees: stock options, restricted share units and the like. The Ontario Superior Court of Justice has recently confirmed that employers may continue to use deferred compensation plans for that purpose, by having employees forfeit any unvested rights when the employment relationship ends. However, the forfeiture must be triggered by the employee's resignation or termination, and not by what the employee does afterward.

The issue: a restraint on trade?

In *Levinsky v Toronto-Dominion Bank*, a senior bank manager resigned his employment and started a new business. According to a forfeiture clause in his restricted share unit plan, by resigning his employment the employee forfeited his right to units worth approximately \$1.6 million, which he had earned but had not yet vested. The employee claimed that the forfeiture clause was invalid and the bank owed him the \$1.6 million.

The primary issue before the court was whether the forfeiture clause acted as a restraint on trade. In other words, did the clause prevent the employee from carrying on certain business activities after his resignation? The employee alleged that the clause was intended to make it difficult to leave the bank's employ and start a competing business. He pointed out that \$1.6 million is a significant sum, and in his case, losing that money significantly delayed establishing his new company and forced him to resort to debt financing in order to do so.

The decision

The court concluded the forfeiture clause was not a restraint on trade. Accordingly, the employee was not entitled to the value of his restricted share units, which were unvested at the time of his resignation.

The court conducted an extensive review of Canadian and international case law. It concluded the question to be asked was whether the forfeiture of compensation was tied to the mere fact of the employment relationship ending, or whether it was tied to what the employee did afterward.

If an employee has to give up compensation merely because he or she resigned or was terminated, the employee can still engage in any business activities afterward. There is no restraint on trade. Employers, the court found, are entitled to use deferred compensation plans to encourage employee loyalty, by paying the compensation only if the employee remains with the company.

On the other hand, if the forfeiture is tied to the employee's post-employment business activities—if, for example, the clause states that the employee will forfeit compensation as soon as he or she begins working for a competitor—then it may well be a restraint on trade, designed to discourage competition. In that case, the forfeiture clause will be valid only if the employer can justify that it is reasonable and necessary to protect legitimate business interests.

The court stressed that when evaluating a forfeiture clause, it is not enough to look at its wording. Equally important are its practical effects.

In *Levinsky*, however, the forfeiture clause did not have the effect of restraining the employee from setting up a competing business after his resignation. Although having an additional \$1.6 million in one's pocket never hurts when starting a company, the employee was still able to found his new business, obtain adequate financing, and even secure his former employer, the bank, as a client. "The simple fact remains," the court said, "that [the employee] was able to choose, without interference from the bank, the commercial activity in which he desired to engage following his resignation."

Lessons for employers

When drafting the terms of deferred compensation plans, *Levinsky* teaches employers to ensure any forfeiture of compensation is tied to the employee's resignation or termination, and not to the employee's post-employment business activities. The model for an enforceable forfeiture clause is one that encourages employee loyalty by requiring the employee to remain employed in order to receive payments, not one that discourages competition after the employment relationship has ended.

Employers should also bear in mind that *Levinsky* focused on the forfeiture of deferred compensation that had not yet vested at the time of the employee's resignation or termination. A plan that provides for the forfeiture of vested rights may be invalid if it is interpreted as a penalty on the employee. This issue is likely to be explored further in future cases.

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