

# Employment Contracts with Post-Employment Obligations

By Josef Rashty

Employment contracts may have post-employment obligations and covenants, including confidentiality agreements, noncompetition agreements, and nonsolicitation agreements. These post-employment agreements usually spell out certain legal obligations that employees have during the post-employment periods, even though their employment services have been terminated and they are no longer employed by the company.

Employers sometimes enforce these restrictive covenants through equity awards. For example, the employment agreements may contain a forfeiture of unpaid equity awards or clawback features for the value of vested and exercised awards if employees fail to honor these post-employment obligations.

The Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Act of 2010 also provide for clawback provisions that, under certain circumstances, require terminated executives to surrender the vested equity awards or the profits that they have realized.

This article discusses the accounting implications of equity awards that are subject to post-performance forfeiture or clawback provisions due to unperformed or underperformed post-performance obligations or the occurrence of certain post-performance events. The guidance for accounting treatment of these transactions is based on Topic 718, "Stock Compensation," and recently issued Accounting Standard Update (ASU) 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*.

## Post-Performance Obligations

In some situations, the end of employment means that a few legal obligations



may continue to linger during the post-employment period.

**Confidentiality agreements.** Employees have a basic common law obligation to render faithful and loyal services to their employer during their employment. As a general rule, employees may leave their employment and lawfully compete against their former employers, taking the knowledge that they have gained during their employment. But they cannot use any of certain information they learned while working for their previous employers, such as trade secrets, confidential information, or customer lists against their employers after they are no longer working for the company—tempting as it might be.

Terminated employees do not necessarily need to physically remove confidential information to violate such obligations. The rules apply to commercially valuable knowledge learned or memorized during the employment as well, which they may use inadvertently as well as consciously. Employers usually obtain a signed, written confidentiality agreement from employees before termination to ensure the strongest claim of restraint against the employee. It would be better, however, if employees signed the confidentiality agreements at the beginning of their employment to satisfy the common-law contract requirement of consideration.

**Noncompete agreements.** In certain cases, employers require employees to sign a noncompete agreement to prevent them from directly competing with their former employers after the termination of the employment agreement. Employers' legal remedy in cases of violation of noncompete agreements is an injunction. Courts generally recognize that noncompetition restrictions distort the free market and are reluctant to enforce them unless there is strong evidence that such competition would threaten the survival of the former employer's business. Thus, in most instances, a convincing case must be made for the courts to exclude employees from competing with their former employers.

**Nonsolicitation agreements.** Employees often wish to maintain relationships with their former coworkers or customers. Is it legal to ask an ex-colleague to join a new employer? Is it legal to ask customers that ex-employees acquired for a previous employer to follow them to a new employer? The legality of these activities is usually determined on a case-by-case basis.

### Enforcement of Restrictive Covenants

Some companies have successfully used equity awards for the enforcement of such restrictive covenants. There are different approaches: for example, the company's termination documents may include forfeiture provisions for unpaid equity awards or clawback provisions to recapture part or all of the value of vested equity awards in case an employee violates the post-performance conditions.

Courts usually try to balance the individual employee's right to move on and earn a living with the former employer's need to protect its legitimate proprietary business interests. Employers should consider whether they need, and can enforce, any post-termination restraints on employees. A company must take the geographical location of the employee's place of employment and the company into account, as well as any state laws regulating noncompete agreements.

Multinational organizations should also be aware that these restrictive covenants may work in some countries, but their enforcement may become problematic in others. The covenant may also face legal challenges if equity awards are viewed as part of regular

compensation and the employee claims entitlement to the award. Nevertheless, in some situations the restrictive covenant on equity awards may work as a deterrent, regardless of its enforceability.

### Post-Performance Events

The Dodd-Frank Act requires the SEC to issue rules barring national exchanges from listing any company that has not implemented a clawback policy that does not include recoupment of incentive-based compensation for current and former executives for a three-year period. The SEC has not yet issued its final regulations on these clawback requirements.

The Dodd-Frank Act's clawback requirements are different than the SOX provisions. Under Dodd-Frank, companies are required to recover compensation, including options, based on materially inaccurate financial information, regardless of misconduct or fault. *Exhibit 1* compares the clawback provisions under these the two acts (Josef Rashty, "The Dodd-Frank Act Addresses Corporate Governance," *The CPA Journal*, April 2012, pp. 40-42).

Even though the SEC has not yet issued the final rules on this provision, several companies are already disclosing their claw-

back policies, likely because proxy advisory firms such as Glass Lewis and Institutional Shareholder Services consider companies' clawback policies when making their "say-on-pay" voting recommendations.

### ASU 2014-12

In June 2014, FASB issued its consensus of the Emerging Issues Task Force as ASU 2014-12. The EITF concluded that a performance target that affects vesting and is achieved after the requisite service period is a performance condition (ASC 718-10-30-28). Thus, compensation cost should be recognized over the required service period if it is probable that the performance condition would be achieved. The total compensation cost should reflect the number of equity awards that are expected to vest and should be adjusted based on the actual forfeiture rate (trued-up) when those awards are ultimately vested.

This consensus provides additional guidance and clarification for the accounting treatment of stock compensation awards that have a right of forfeiture or clawback during the post-performance period. Under this guidance, an entity should not record compensation cost until it is probable that the performance target will be achieved. Furthermore, performance conditions affect

## EXHIBIT 1 Comparing Clawback Provisions

Clawback Provisions	Sarbanes-Oxley Act	Dodd-Frank Act
Scope	Accounting restatement due to material noncompliance with the securities laws as a result of misconduct	Accounting restatement due to material noncompliance with any financial reporting requirements under the securities laws
Recovery	Amount received as incentive-based compensation and profits realized from stock sales	Erroneously awarded incentive-based compensation (including stock options) in excess of the amount that would have been paid under the restatement
Applicability	CEOs and CFOs	All current and former executive officers
Period covered	12 months	3 years

only the vesting condition of stock compensation awards and do not impact the estimate of the award's grant-date fair value.

ASU 2014-12 is effective for all entities for annual periods beginning after December 15, 2015, and interim periods within those years. The guidance can be adopted on a prospective basis, but it can also be applied on a modified prospective basis for performance targets outstanding on or after the beginning of the first annual period presented as of the adoption date. Early adoption is permitted.

### ASC 718—Contingent Provisions

Clawbacks, the contingent provisions in equity awards, are used for the enforcement of confidentiality, noncompete, and nonsolicitation covenants. These clawback provisions may also be triggered by other events, such as the restatement of financial statements, as required by the Dodd-Frank Act. Contingent provisions of equity awards, like forfeiture provisions, do not impact the estimate of the grant-date fair value (ASC 718-10-30-24 and ASC 718-10-55-8). Instead, the effect of such contingent provisions should be accounted for, if and when the contingent events occur (ASC 718-10-55-47).

If the clawback feature is triggered and the employee must return the gain realized

on the exercise of an option or sale of shares, or must return shares in exchange for consideration in an amount less than their current fair value, the company should recognize the appropriate debit amount as either cash or treasury stock on its balance sheet. ASC 718-10-55-47 requires that an offsetting credit should be recognized in the statement of operations in an amount equal to the lesser of (1) the recognized compensation cost or (2) the current fair value of the consideration received. The excess of the fair value of the consideration received and the amount recorded in the statement of operations (equal to stock compensation recognized) must be recorded as additional-paid-in-capital.

The guidance views the clawback provision as different than the forfeiture provision. The clawback provision is related to a transaction that has taken place with a current or former employee as a result of a current or former employment relationship, whereas the forfeiture provision is related to a current employee as an equity owner. *Exhibit 2* summarizes the accounting implications of the clawback provision in the accounting guidance.

### Noncompete Provisions

Examples 10 and 11 in ASC 718-20-55 have addressed the issue of noncom-

pete clauses in employment contracts. Example 10 concludes that noncompete arrangements do not affect the requisite service period. Thus, stock compensation expense should be recognized ratably over the stated vesting terms, regardless of the existence of a noncompete arrangement.

Example 11, on the other hand, appears to imply that noncompete provisions create in-substance requisite service periods. The recognition of stock compensation should be extended to the duration of the obligation. The circumstances that FASB describes in Example 11, however, are different from Example 10. In Example 11, all awards are vested immediately and are significant to total compensation. Furthermore, the units are transferable to the employee based on a delayed-transfer schedule, whereas in Example 10 the equity awards are exercisable upon vesting and are proportionate to total compensation.

Companies generally avoid the model in Example 11 because it may have tax implications under IRC section 409A. Section 409A created new requirements for non-qualified deferred compensation arrangements and imposes significant penalties if certain arrangements do not comply with such requirements. Section 409A could apply in certain cases to separation arrangements and post-employment payments [Sullivan & Worcester LLP, 2008, "Section 409A Questions and Answers," [http://www.sandw.com/assets/html/documents/CLIENT\\_ADV\\_-\\_A\\_Question\\_and\\_Answer\\_Guide\\_409A\\_\(B0778012\).PDF](http://www.sandw.com/assets/html/documents/CLIENT_ADV_-_A_Question_and_Answer_Guide_409A_(B0778012).PDF)].

Therefore, based on the guidance in ASC 718 and ASU 2014-12, noncompete and other post-performance arrangements and events do not impact the fair value and the requisite service period of the awards in most instances; however, they may impact the forfeiture rates.

The following example depicts the application of ASC 718 and recently issued ASU 2014-12.

### Example

At the beginning of 20X4, Entity A grants its Chief Executive Officer (CEO) 4,000 nonqualified stock options and 4,000 restricted stock units (RSU). The equity awards will vest in four years (annual

## EXHIBIT 2

### Summary of the Accounting Implications of the Clawback Provisions

Clawback or Forfeiture Event	Accounting Treatment
Forfeiture of options or restricted stock units not vested but employee has rendered services and company has recognized the compensation expense	Reversal of stock compensation expense and adjustment of forfeiture rate
Clawback of options or restricted stock units vested (the fair market value of equity awards is equal or less than grant date fair value)	Company records offsetting entry as other income in the statement of operations
Clawback of options or restricted stock units vested (the fair market value of equity awards is greater than grant date fair value)	Company records offsetting entry as other income (to the extent that stock compensation expense equal to grant date fair value has been recognized) in the statement of operations  Excess of fair market value of the equity awards over the grant date fair value (stock compensation recognized) reflected in additional paid-in-capital

cliff vesting; 25% every year). The equity awards become freely transferable upon vesting annually.

The equity awards also are tied to certain post-performance obligations (i.e., noncompetition, nonsolicitation, confidentiality) and are subject to the following forfeiture and clawback provisions if post-performance obligations are violated:

- All unvested awards outstanding will be forfeited.
- If the CEO has sold certain equity awards during the year prior to his termination, he must return 50% of the gains he has realized in the transaction to Entity A.
- For awards vested but not sold, the CEO must return 50% of the equity awards vested to Entity A with no consideration.

The fair market values of stock options and RSUs granted at the beginning of 20X4 were \$5 per share and \$10 per share, respectively. The closing price of Entity A's stock at the anniversary of the grant and at the time of termination was \$12 per share.

The CEO of Entity A, 18 months after he begins employment, voluntarily terminates his services and is subsequently hired by a direct competitor. He exercised 1,000 RSUs vested for \$12 per share at the anniversary of the grant and realized a gain of \$12,000 (1,000 RSU awards × \$12). The 1,000 options vested were still outstanding at the time of termination.

Entity A has used the 10% forfeiture rate for the equity awards granted to its executives and its policy is to true-up the forfeiture rates (adjusting estimated forfeiture rates to actual) when all the equity awards in each particular grant are fully vested or cancelled.

The following journal entries reflect the equity transactions during the CEO's employment and post-employment. The tax impact has not been taken into account.

### Journal Entries during Employment

The quarterly journal entries for 20X4 are as follows:

#### Stock Options

Stock Compensation	\$1,125
Additional Paid-In-Capital	\$1,125

*250 options vested quarterly × \$5 fair market value, less 10% forfeiture rate.*

#### RSUs

Stock Compensation	\$2,250
Additional Paid-In-Capital	\$2,250

*250 RSUs vested quarterly × \$10 fair market value, less 10% forfeiture rate*

### Journal Entries after Termination

The CEO terminates his employment at the end of the second quarter of 20X5, thus forfeiting his unvested stock options and RSUs. Because Entity A has made journal entries for the stock compensation for the first two quarters of 20X5, it reverses these journal entries and true-ups the forfeiture reserve.

#### Stock Options

Additional Paid-In-Capital	\$2,500
Stock Compensation	\$2,500

*Reversal of journal entries for the first two quarters of 20X5 (\$1,250 × 2)*

Stock Compensation	\$250
Additional Paid-In-Capital	\$250

*To true-up the forfeiture reserve for 20X4 (\$1,250 – \$1,125 × 2)*

#### RSUs

Additional Paid-In-Capital	\$5,000
Stock Compensation	\$5,000

*Reversal of journal entries for the first two quarters of 20X5 (\$2,500 × 2)*

Stock Compensation	\$500
Additional Paid-In-Capital	\$500

*To true-up the forfeiture reserve for 20X4 (\$2,500 – \$2,250 × 2)*

Furthermore, the CEO should return 50% of the amount of gain that he has realized for the exercise of RSUs vested at the end of the fiscal 20X4. If the market value of the stock at the time of exercise were \$12, the journal entry for the recapture of the gain realized would have been as follows:

Cash	\$6,000
Other Income	\$5,000
Additional Paid-In-Capital	\$1,000

$6,000 = (\$12 \times 1,000) \div 2$

*\$5,000 is half the stock compensation recognized in 20X4. Income recognized should be limited to the lesser of the fair market value of the stock or stock compensation recognized.*

If the market value of the stock at the time of exercise were only \$8, however, the journal entry would have been as follows:

Cash	\$4,000
Other Income	\$4,000

$4,000 = (\$8 \times 1,000) \div 2$ . *Income recognized should be limited to the lesser of the fair market value of the stock or stock compensation recognized.*

Moreover, 50% of the stock options vested are subject to clawback. If the market value of the stock at the time of clawback were \$12, the journal entry would have been as follows:

Treasury stock	\$6,000
Other Income	\$2,500
Additional Paid-In-Capital	\$3,500

$6,000 = (\$12 \times 1,000) \div 2$ . *\$2,500 is half of stock compensation recognized in 20X4. Income recognized should be limited to the lesser of the fair market value of the stock or stock compensation recognized.*

If the market value of the stock at the time of clawback were only \$4, however, the journal entry would have been as follows:

Treasury Stock	\$2,000
Other Income	\$2,000

$2,000 = (\$4 \times 1,000) \div 2$ . *Income recognized should be limited to the lesser of the fair market value of the stock or stock compensation recognized.*

### Final Considerations

Employment contracts may have post-employment obligations and covenants, and companies sometimes enforce these restrictive covenants through the equity awards by the forfeiture of unpaid equity awards or the clawback of such awards in case of breach of covenants. Furthermore, SOX and Dodd-Frank also include clawback provisions that require executives to surrender the vested equity awards under certain circumstances.

The accounting implications of stock compensation awards that are subject to post-performance forfeiture or clawback due to certain obligations or the occurrence of certain events are based on Topic 718, "Stock Compensation" and recently issued ASU 2014-12. The recently issued guidance enumerates that post-performance obligations or events do not impact the fair market value of equity awards or their requisite service periods, but they may impact the forfeiture rate. □

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