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Texas Supreme Court Rules for Exxon: A New Day for Noncompete-Triggered Forfeitures in Texas?

By Scott McDonald

On August 29, 2014, the Texas Supreme Court in *Exxon Mobil Corp. v. Drennen*[1] upheld a noncompete-triggered forfeiture provision in an executive compensation plan that applied New York law. This is a landmark decision in a number of important ways discussed below, but did it signal a new day for noncompete-triggered forfeiture clauses in Texas? Maybe, maybe not. Despite making a number of very important rulings on public policy, choice of law, and what it considers to be a "covenant not to compete," the Texas Supreme Court intentionally left the fundamental issue of enforceability of detrimental-activity provisions (*i.e.*, noncompete-triggered forfeiture clauses) under Texas law undecided.

The heart of the court's ruling turned on the choice of law decision and is summed up nicely at the end of the case:

> While Texas law may or may not permit the enforcement of these detrimental-activity provisions, New York law does. Application of New York law, resulting in the enforcement of these provisions, does not contravene any fundamental policy in Texas. Accordingly, without determining the enforceability of the detrimental-activity provisions under Texas law, we reverse the court of appeals' judgment and, applying New York law, render a take-nothing judgment for ExxonMobil in accordance with the trial court's judgment.

So, if the court did not decide the noncompete-triggered forfeiture issue based on Texas law, why should this be considered a landmark Texas decision? The answer lies in how the court got to the conclusion it describes above—getting to this result required some major shifts away from historic precedent.

Factual Background

The plaintiff worked for ExxonMobil for over 30 years. He received incentive compensation under a variety of programs, some of which involved shares in the company with delayed delivery provisions (*e.g.*, 50% of the shares delivered three years after a grant, and 50% delivered seven years after a grant). The program agreements contained New York choice of law provisions. The

1 Case No. 12-0621 (opinion delivered Aug. 29, 2014).

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programs contained termination provisions that allowed ExxonMobil to terminate outstanding awards under certain conditions. Engaging in "detrimental activity" was one such condition. "Detrimental Activity" was defined as "acceptance ... of duties to a third party under circumstances that create a material conflict of interest," and "material conflict of interest" included becoming employed "by an entity that regulates, deals with, or competes with the Corporation or an affiliate."

The plaintiff was told his job at the company was likely to change and in response, he chose to resign and go to work for a competitor. The plaintiff had 57,200 shares still in the restricted period when he resigned. ExxonMobil cancelled the outstanding shares due to his undertaking a "detrimental activity."

Litigation ensued and the case made its way to trial. At trial, there were a number of issues submitted to the jury about whether the nature of the restrictions in the program had been changed orally, creating a new contract, or waived through alleged statements made to the plaintiff. The jury decided against the plaintiff and for the company on these various breach of contract, oral modification, and waiver/estoppel theories. The plaintiff then moved for judgment by the court on the theory that the "detrimental activity" provisions ExxonMobil relied upon were, as a matter of law, a form of unenforceable noncompete agreement under Texas law. The trial court disagreed and found he was not entitled to the shares. On appeal, however, the intermediate appellate court agreed with the plaintiff and ruled that Texas law applied, and that under Texas law, the provision was unenforceable. This decision was then appealed to the Texas Supreme Court.

Choice of Law

The court first looked at the choice of law issue. The court concluded that New York law applied, but how it got there involved a number of game-changing decisions under Texas law.

The court applied the same Restatement (Second) of Conflict of Laws § 187 test it had previously applied in *DeSantis v. Wackenhut Corp*, 793 S.W.2d 670, 677 (Tex. 1990) where it had concluded that a Florida choice of law provision in a noncompete contract would *not* be honored. In short, the Restatement test looks at: (a) whether there is no substantial relationship between the transaction and the state chosen, and (b) if application of the law chosen would violate a fundamental public policy of a state with a materially greater interest than the one chosen.

The first element of this test is the need for a relationship between the contract and the state chosen. Here, ExxonMobil's incentive programs provided for application of New York law but ExxonMobil is headquartered in Texas and incorporated in New Jersey. The plaintiff lived in Texas. Although he had, at one earlier point in his career (in the '80s) lived and worked for Exxon in New York, he was not doing so at the time of the awards at issue. To find a relationship to New York, the court focused on several seemingly attenuated considerations. It pointed out that the company's outside counsel was a New York law firm. It noted that the company's shares were traded on the New York stock exchange and valued on that exchange. The court never really expressly said these connections qualify as "substantial," but stated that the Restatement requires only that the choice to be sufficiently close to the parties' contract to be reasonable. It concluded these connections to New York were sufficient. This is a significantly different focus from the one seen in *DeSantis*, and is the first of the court's landmark moves.

The court then addressed the second part of the test and concluded that the state with the most significant relationship to the transaction is Texas, and that Texas has a materially greater interest in the transaction than New York. These conclusions were consistent with the analysis seen earlier in *DeSantis*. However, in applying the "fundamental public policy" part of the analysis, the court applied a big, new twist. The court concluded that the contract at issue was not a covenant not to compete, and thus not on a collision course with fundamental Texas public policy—at least not in the same way that the *DeSantis* noncompete contract was. In the course of addressing the public policy issue, the court said a number of things that will likely be important precedent for the future:

- The court defined what a noncompete is, adopting a statement from *Marsh USA Inc v. Cook*: "[c]ovenants that place limits on former employees' professional mobility or restrict their solicitation of former employers' customers and employees ..." 354 S.W.3d 764, 768 (Tex. 2011). It then concluded that the forfeiture clause did not fit this definition.
- The court recognized a distinction "between an employer's desire to protect an investment and an employer's desire to reward loyalty." The court emphasized that forfeiture provisions conditioned on loyalty reward loyalty rather than prohibit future employment opportunities, making them different from covenants not to compete.

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- The court suggested that a forfeiture provision might still be unenforceable as an unreasonable restraint of trade under Texas law, even if it is not a covenant not to compete, citing *Peat Marwick Main & Co. v. Haass*, 818 S.W.2d 381 (Tex. 1991). But, it did not have to decide that issue because it applied New York law (saying it is a "separate question and one which we reserve for another day.").
- The court signaled that it is stepping away from *DeSantis* on the public policy issue, stating "the policy concerns regarding uniformity of law raised in *DeSantis* have changed in the past twenty-four years." It noted that Texas now hosts many of the world's largest corporations, and "our public policy has shifted from a patriarchal one in which we valued uniform treatment of Texas employees from one employer to the next above all else, to one in which we also value the ability of a company to maintain uniformity in its employment contracts across all employees, whether the individual employees reside in Texas or New York."

The court ultimately concluded that when the importance of allowing parties to use contracts to gain uniformity is factored in "we cannot conclude that applying New York law [to a forfeiture provision] is 'contrary to a fundamental policy' of Texas."

Once the court had decided that the forfeiture clause would be governed by New York law, it made short work of the enforceability issue. The "employee choice" doctrine of New York provides that "a restrictive covenant will be enforceable without regard to reasonableness" so long as the employee voluntarily left his or her employment or was terminated for cause. *Morris v. Schroder Capital Management Int'l*, 859 N.E.2d 503, 507 (N.Y. 2006). Consequently, the plaintiff's reasonableness challenges to factors such as lack of geography in the "detrimental activity" restriction were irrelevant. New York precedent enforces agreements where the employee had a "choice of preserving his rights under the [incentive programs] by refraining from competition ... or risking forfeiture of such rights by exercising his right to compete... ." *Lenel Sys. Int'l, Inc. v. Smith*, 966 N.Y.S.2d 618, 621 (N.Y. App Div. 2013). The plaintiff was making exactly this kind of choice.

Action Items and Takeaways

- Multi-state employers that have been reluctant to consider using a choice-of-law clause in a restrictive covenant agreement—particularly a forfeiture-oriented compensation program—should re-evaluate this option. The court has signaled a much greater acceptance of arguments related to the need for uniformity via choice-of-law selection when employees are spread across multiple states. And, the court applied a fairly loose test on the need for a connection between the state law chosen and the transaction at issue.
- Employers that rely solely upon either an ordinary noncompete contract in an employment agreement or a restrictive covenant in a deferred compensation plan should look at the possibility of using both and distinguishing between the remedies available under each. And employers that already use both should examine the advantage of having distinctly different remedies under each. The Texas Supreme Court appears to recognize a distinction between a forfeiture-only remedy (in the compensation plan) and one that provides for injunctive relief that would prohibit the employee from competing (usually in an employment agreement). If both remedies are contained in the same contract, the distinction may not be as useful.
- Employers that do not want to put a noncompete in place but would still like to create a disincentive to disloyalty by departing employees will want to consider the advantages and disadvantages of the type of forfeiture clause enforced in *ExxonMobil v. Drennan*. The advantages are that it can be worded more broadly, can be enforced via another state's law if such is available, and may not be viewed with as much hostility under Texas law. And, it can be enforced through a plan administrator's decision without having to go to court. The disadvantages are that it acts only as a financial deterrent. It does not prevent the employee from going to a competitor. It creates only a financial price for doing so. And, the competitor may cover the employee's loss which would negate the disincentive.
- Finally, employers should not assume forfeiture clauses are now automatically enforceable in Texas. The Texas Supreme Court's decision did not decide whether a broadly worded noncompete-triggered forfeiture clause is enforceable or unenforceable under Texas law. The court was clear about reserving this question for another day. Consequently, a level of uncertainty remains in place for these clauses when Texas law is the controlling law.

Scott McDonald is a Shareholder in Littler's Dallas office. If you would like further information, please contact your Littler attorney at 1.888.Littler or info@littler.com, or Mr. McDonald at smcdonald@littler.com.

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