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A Covenant Not to Compete or a Forfeiture Clause?

A Distinction That Matters

By: Locke Lord's Labor & Employment Practice Group

The Supreme Court of Texas recently issued its long-awaited opinion in the case of *Drennen v. Exxon Mobil Corporation*, and in doing so has approved an alternative approach for employers to garner periods of noncompetition from prior employees. This decision continues the Texas Supreme Court's recent trend towards broader enforcement of restrictive covenants.

Drennen worked as a geologist for ExxonMobil for over 31 years, and eventually retired as Exploration Vice President-Americas, working at ExxonMobil Exploration Company in Houston, Texas. As part of his compensation, ExxonMobil awarded Drennen incentive compensation, including awards of restricted stock and "earnings-bonus units" under ExxonMobil's Incentive Programs. The Incentive Programs chose New York as the governing law and included provisions allowing ExxonMobil to cancel the incentive awards of employees who engage in "detrimental activity." The 2003 Incentive Program defined "detrimental activity" to potentially include employment or engagement by an entity that regulates, deals with, or competes with ExxonMobil. After retiring from ExxonMobil, Drennen accepted a position with Hess Corporation. ExxonMobil informed Drennen that it was cancelling all of his remaining incentive awards, and Drennen sued to prevent enforcement of the "detrimental activity" clause. Drennen was not successful at the trial court, and he appealed.

On appeal, the issues were whether the "detrimental activity" clauses in the Incentive Programs were covenants not to compete under New York and Texas law, and, if so, which law applied. The Houston Fourteenth Court of Appeals held that under both states' laws, the "detrimental activity" clauses were covenants not to compete. Under New York law the clauses were enforceable based on the "employee choice" doctrine recognized in New York. That doctrine allows for enforcement of even unreasonable restraints of trade if an employee that was terminated for cause or voluntarily terminated their employment is given the choice to either: (1) preserve his or her rights under the contract by refraining from competition; or (2) forfeit such rights by exercising the right to compete. By contrast, under Texas law the clauses were unenforceable as covenants not to compete because the clauses lacked reasonable limitations as to time, geographical area, and scope of activity to be restrained.

The appellate court next turned to the issue of which law to apply. In determining that Texas law applied over the parties' choice of New York law in the Incentive Programs, the appellate court made three necessary findings: (1) Texas has a more significant relationship with the parties and their transaction than New York; (2) Texas has a materially greater interest in the determination of whether the noncompetition provision is enforceable than New York; and (3) the application of New York law would be contrary to Texas fundamental public policy –whether non-competition agreements are reasonable restraints upon employees who live and work in Texas.

The Supreme Court of Texas reversed and rendered judgment in favor of ExxonMobil. In doing so, the Court initially found that there was a reasonable relationship between the parties, the Incentive Programs and New York. This decision was based, in part, on the fact that ExxonMobil provides

incentive awards to employees throughout the U.S. and in numerous countries and needs consistency in these awards, and that ExxonMobil's stock is traded in New York, which has a well-developed body of law concerning stock and incentive plans, securities and financial transactions. The Court then reviewed which state had a more significant relationship with the parties and their transactions and a materially greater interest in the determination of whether the forfeiture provisions are enforceable. Like the appellate court, the Court found in favor of Texas as to both questions relying on Drennen being a Texas resident, ExxonMobil's headquarters being located in Texas, and the execution and performance of the Incentive Programs occurring in Texas. But, the Court disagreed as to the public policy issue and held that applying New York law as specified in the Incentive Agreements would not be contrary to fundamental Texas public policy because the "forfeiture" provisions were not covenants not to compete under Texas law. According to the Court, "there is a distinction between a covenant not to compete and a 'forfeiture' provision in a non-contributory profit-sharing plan because such plans do not restrict the employee's right to future employment; rather, these plans force the employee to choose between [(a)] competing with the former employer without restraint from the former employer [or (b)] accepting benefits of the retirement plan to which the employee contributed nothing." The Court then explained Texas's public policy has shifted over the last 20 plus years from "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," by promoting orderly employer-employee relations within those multistate companies. Having determined that New York law applied, the Court found the "forfeiture" provision to be enforceable under New York's "employee choice" doctrine.

The *Drennen* decision has significant implications for companies seeking to rely on "forfeiture" provisions to curb competition by former employees. The Texas Supreme Court has opened the door for employers to use such forfeiture clauses as another tool to prevent competition or, as the Court characterized it, encourage loyalty from a departing employee, if the employer is able to establish a reasonable basis for applying New York or another state's law that enforces such provisions. The Court did so by holding that: (1) forfeiture provisions of non-contributory incentive plans are not covenants not to compete under Texas law; and (2) the enforcement of the parties' choice of New York law did not conflict with Texas public policy. Employers are left with uncertainty as to whether Texas law allows the enforcement of such "forfeiture" provisions because the *Drennen* court did not decide whether the "forfeiture" provision constitutes an unlawful restraint of trade under Texas law. Specifically, the Court stated this "is a separate question and one which we reserve for another day." When this question is eventually answered, it is not clear how much impact the Court's statement of Texas's shifted public policy will have. Therefore, the Court has left employers and employees the opportunity to enter into similar forfeiture or loyalty contracts in a "buyer beware atmosphere" as to their enforceability under Texas law. Until such time as the Supreme Court of Texas addresses this issue, Texas courts will address the enforceability of forfeiture clauses under Texas law and attempt to predict whether the Texas Supreme Court will eventually agree with their reasoning and analysis.

Employers' options for requiring post-employment restrictions have expanded over the last eight years since the Court first found a non-compete to be enforceable under the Covenants Not to Compete Act, and that expansion continues with the *Drennen* decision. As a result, now is a good time for employers to review the different ways to protect company assets upon employee departures, and to draft employment agreements and equity benefit plans accordingly.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact a member of Locke Lord's Labor & Employment Practice Group.