BNA, INC.

PENSION & BENEFITS

BNA Employee-Owned Since 1947

DAILY

Postemployment Restrictive Covenants at the Executive Level

By Paulo B. McKeeby

I. Introduction

Employers routinely utilize creative incentive-based methods for retaining high-level executives. This article touches on deterrent-related methods of keeping top talent, or at least minimizing the likelihood that top talent will compete with an incumbent employer and potentially compromise that employer's confidential information and/or goodwill with customers or other business contacts.

Specifically, this article will address agreements that restrict executive mobility and protect employer information. These types of agreements come in a variety of forms as discussed in more detail herein. Many agreements attempt to limit an employee's ability to work for a competitor, typically within a geographic or product range. Other agreements, which tend to be easier to enforce, seek to restrict employees from soliciting or servicing customers with whom they had business contact during their previous employment. These agreements all fall within the practitioner's definition of a postemployment ''restrictive covenant.''

More specifically, this article will address the following three issues that frequently arise in noncompete and related covenants between companies and high-level executives:

(1) To what extent can choice-of-law or choice of venue provisions provide greater predictability as to outcomes in the event of breach of postemployment restrictions on competition?

(2) How are courts addressing the reality of executive mobility, which can create competitive harm without regard to traditional geographic restrictions?

(3) To what extent are agreements that require forfeiture of incentive or other compensation viable alternatives to traditional restrictive covenants?

The analysis below is not intended to offer definitive guidance or answers to the questions above. Even a cursory review of any noncompete treatise quickly reveals the state-specific nature of the legal issues that frequently can be outcome determinative in this context. Practitioners in this area would emphatically concur, as the ''enforceability'' of a particular restrictive covenant often turns on a variety of factors, some of which are tied to the text of a particular contract. Indeed, the answer to a client's question as to whether a particular noncompete agreement is enforceable almost invariably is, ''it depends.'' Nor does this article offer a definition of ''high-level executive,'' as it is assumed that designation may vary from industry to industry. Hopefully, the analysis below will offer some points of con-

Paulo B. McKeeby is a partner in the Labor and Employment Practice at Morgan Lewis & Bockius, resident in the firm's Dallas office. He is co-chair of the Noncompete and Trade Secrets task force.

sideration and insight that might be valuable in informing the negotiation dialogue as well as the drafting of agreements between corporations and executive employees.

II. Choice-of-Law and Forum-Selection Clauses

The question of what state's law applies to the construction of a covenant not to compete is often critical in noncompete litigation, particularly in cases of highly mobile executive employees. For example, assume an executive employee resides in Texas, is ''based'' out of an office in Illinois to which he commutes during the week, and is signatory to a noncompete agreement that contains a Delaware choice–of-law provision. Assume further that the executive is offered a job by a new employer that would require him to move to and work in Colorado.

This fact pattern is by no means unusual and requires the practitioner to wade through a morass of conflict of law, jurisdictional, and other procedural issues. Advising a client with any degree of certainty at the outset of such a scenario is almost impossible. Predicting outcomes requires weighing considerations such as where the suit is filed and which state's law ultimately will be applied. The answers are unclear from the above-described hypothetical fact pattern. The case law, once again, tends to be state-specific and, as a result, offers limited guidance.

One overriding principle that applies in most states is a general reluctance to honor contractual choice-of-law provisions in the context of noncompete agreements, particularly where there is the appearance of a conflict between the law of the chosen state and the law of the forum state. For example, in *Keener v. Convergys*,[1] an employee of an Ohio company relocated to Georgia after having signed a two-year noncompete agreement. The court, applying Georgia law, emphasized that ''the contract was entered into in Ohio, the contract selected Ohio law, and it was the expectation of both parties that Ohio law would apply.''[2] Despite these considerations, the court of appeals affirmed a district court order granting summary judgment to the plaintiff on the grounds that the noncompete agreement was contrary to Georgia public policy and that Georgia law therefore should be applied. The court emphasized Georgia's inherent interest in regulating competition within its borders and determined that this interest overrode the parties' selection of the law of another state to govern the postemployment competition rights and obligations between them.

California courts have taken a similar approach. In *Application Group v. Hunter*,[3] a Maryland employer sought to enforce a restrictive covenant containing a Maryland choice-of-law clause against a former employee who intended to relocate to California to work in that state. Even though the defendant employee had never been a resident of California, the California appellate court held that California had a materially greater interest than Maryland in the dispute, that California law therefore applied, and that the covenant not to compete was unenforceable under California Business & Professions Code Section 16600. The court emphasized that enforcing the Maryland choice-of-law clause would allow an out-of-state employer to limit opportunities in California and emphasized that ''California courts are not bound to enforce a contractual choice of law provision which would. . .be contrary to the state's fundamental public policy.'' [4]

The variances in state laws with respect to covenants not to compete have resulted in races to the courthouse, as parties on both ends of the litigation seek to take advantage of the differences in state laws. These cases arise, either in the context of an employer seeking to obtain relief under a contract to prevent unfair competition or an employee seeking a declaration from a particular court as to the parties' rights and responsibilities under a particular contract.[5]

Accordingly, employers are not able to obtain predictability to overcome differences in state laws simply through the inclusion of a choice-of-law provision in the underlying contract. The courts in many states, particularly those such as Georgia and California where noncompete covenants are either prohibited or permitted in vary narrow circumstances, simply will not recognize the contractual choice-of law-provision. A preferable option, although one that does not involve complete predictability either, is a forum-selection provision. Such a provision would state that the parties agree that any dispute under the contract, including enforcement of noncompete covenants, would take place in an exclusive and chosen venue. For whatever reason, these types of clauses have proven more resilient than choice-of-law clauses and, at least in some situations, can be potentially outcome determinative.

An interesting example comes from Texas in the case of *In re AutoNation, Inc.*[6] In that case, the employer automobile dealership sued its former employee in Florida to enforce a covenant not to compete, which contained a forum-selection provision whereby the parties agreed to litigate any disputes under the contract in Florida under Florida law. The employee was a Texas resident who managed a car dealership in Texas that was owned and operated by the employer, whose principal place of business and corporate headquarters were in Florida. The employee left AutoNation to accept a position with a competing Mercedes Benz dealership, also located in Texas. Thereafter, AutoNation sought enforcement of the noncompete provisions by filing a suit for injunctive relief and damages against the employee in Broward County, Florida. After that suit had been filed, but before learning of the litigation, the employee filed a declaratory judgment action in Texas. In his lawsuit, the

[1] 342 F.3d 1264 (11th Cir. 2003).
[2] *Id.* at 1268 n.2.
[3] 72 Cal. Rptr. 2d 73 (Cal. Ct. App. 1998).
[4] See also *Elec. Distributors, Inc. v. SFR, Inc.*, 166 F.3d 1074 (10th Cir. 1999) (applying Utah law despite the parties' selection of a Colorado choice-of-law provision in their noncompete covenant because Utah had a materially greater interest in the resolution of the issues, and important public policy considerations of Utah were involved in assessing the validity of the noncompete).
[5] *See, e.g.*, *Advanced Bionics Corp. v. Medtronic, Inc.*, 29 Cal. 4th 697 (2002) (finding that California's refusal to enforce noncompete agreement did not justify an injunction barring an employer from suing in Minnesota to prevent an employee from working for a competitor in California); *Medtronic, Inc. v. Advanced Bionics Corp.*, 630 N.W.2d 438 (Minn. App. 2001) (addressing employer's alleged bad-faith attempt to remove case and finding that these efforts did not amount to unclean hands that would preclude enforcement of a covenant not to compete).
[6] 228 S.W.3d 663 (Tex. 2007).

  ISSN

employee sought a judicial determination that, as a Texas citizen working in Texas, his noncompete obligations should be governed by Texas law.

After learning of the Florida litigation, the employee filed an application for a temporary restraining order and motion for a temporary injunction in the Texas action, arguing that Texas law should govern a Texas resident's noncompete obligations and that AutoNation was attempting to circumvent Texas law by pursuing the Florida action because a Florida court likely would not apply Texas law in deciding the enforceability of the noncompete agreement. The employee relied on a 1990 Texas Supreme Court case *DeSantis v. Wackenhut Corp.*[7] In *DeSantis*, the court held that enforcement of noncompete covenants was a matter of fundamental Texas public policy and should be governed, with respect to Texas residents, by Texas law. In the *DeSantis* case, the court refused to apply a contractual Florida choice-of-law provision and struck down an underlying noncompete covenant.

The court in *AutoNation* was not persuaded that *DeSantis* controlled the outcome. While the Texas Supreme Court stated that, if it heard the case, it likely would have disregarded the Florida choice–of-law provision for public policy reasons, it observed:

> We have never declared that fundamental public policy requires that every employment dispute with a Texas resident must be litigated in Texas . . . even if precedent requires Texas courts to apply Texas law to certain employment disputes, it does not require suits to be brought in Texas when a forum selection clause mandates venue elsewhere. [8]

The *AutoNation* case involved a race to the courthouse along the lines described above. Had the employee in *AutoNation* filed his lawsuit before the employer initiated litigation in Florida, it is conceivable that the case may have come out differently. Nonetheless, while the court did express reservation about interfering with the jurisdiction of the Florida court, the language of the decision suggests it was based more on the sanctity of the parties' selection of Florida as the exclusive venue for litigation of any disputes under the contract. Accordingly, the lesson of *AutoNation* may be that a forum-selection clause is more likely to be enforced than choice of law provision and may be a more preferable means of securing predictability than a choice-of-law provision.

III. The Challenge of Identifying Appropriate Geographic Limitations in Noncompete Agreements With Executive-Level Employees

One of the most significant challenges for drafters of modern covenants not to compete is selecting the appropriate, and lawful, geographic scope of the postemployment prohibition on competition. The Restatement of Contracts, as well as the laws of nearly all of the states where noncompete agreements—that is, agreements that limit an employee's ability to work for a competitor after the employment relationship—are lawful, require that the agreement contain some reasonable geographic limitations with respect to the scope of the noncompete prohibitions. Some states, such as Louisiana, require that the noncompete agreement specifically list the locations in which competition is to be restrained.[9] Most states, however, require simply that the geographic limitation be ''reasonable'' and leave it to the courts to figure out what is reasonable in particular circumstances. Some states liberally permit courts to reform or ''blue pencil'' overly broad noncompete agreements, such that a stated geographic restriction may not be the one ultimately enforced by a court. In these states, the scope of the noncompete agreement identified in the contract may not be critical. Other states, such as Georgia, strictly prohibit reformation of noncompete agreements. In those states, if the drafter does not get the geographic restriction right at the time the agreement is written, the agreement will not be enforced at all.

The traditional rules relating to geographic limitations in noncompete agreements create peculiar challenges for drafting these types of agreements in the context of the modern executive. Under the case law of most states, a reasonable geographic limitation typically means a portion of the state, the entire state, or a radius measured typically from the location at which the employee worked or provided services. These types of limitations have worked and still work well in certain contexts. For example, an appropriately narrow geographic scope for a sales executive might be the territory to which he or she was assigned during his or her employment. In the traditional retail context, the area in which customers likely were to originate might be an appropriately narrow geographic limitation in a postemployment prohibition on competition.

These rules do not work nearly as well in the context of the modern executive. Many companies simply will not care if an executive performs services for a competitor down the street, in the next office building, or across the country in a different state. The particular location of employment simply does not matter in many industries for many levels of employment where the interests to be protected are not particular customers or customer goodwill, but rather high-level trade secrets, company strategies, or national or overseas purchasing resources. For these kinds of employees, the traditional rules regarding geographic limitations typically do not work.

Fortunately, there is emerging authority in the case law, at least in some states, that recognizes the economic realities associated with certain high-level positions and that the traditional rules regarding geographic limitations are inadequate. For example, in *PrecisionIR Inc. v. Clepper*,[10] the court, applying Virginia law, considered a noncompete agreement that limited competition, as well as customer solicitation, anywhere in the United States or Canada. The former employee predictably argued that these geographic restrictions were overly broad. The court disagreed. It focused on the employer's business of providing organizations with Web casting and related services and emphasized that the Internet-based nature of the business covered the expanse of the entire United States and Canada. The court also attached significance to a clause in the agreement whereby the parties had acknowledged that the geographic scope of the restriction on competition was reasonable because the employer had clients and did

[7] 793 S.W.2d 670 (Tex. 1990).
[8] *In re AutoNation* at 669.
[9] *See* Louisiana Revised Statutes 23:921(C).
[10] 693 F. Supp. 2d 286 (S.D.N.Y. 2010).

business over the Internet and through other media throughout the United States and Canada.

Similarly, in *Philips Electronics N. Am. Corp. v. Hope*,[11] the defendant employee was a former vice president of sales who was assigned to work with customers throughout the United States and Canada. The covenant provided for alternative geographic scopes, one of which was any location where the company carried on or transacted business or sold or marketed its products or services. These provisions encompassed the entire United States based on the locations where the company did business or marketed its products. The court, applying North Carolina law, rejected the defendant employee's arguments that these restrictions were overly broad. Noting that nationwide restrictions had been upheld under North Carolina law, the court determined there was sufficient basis for the scope of the noncompete and that it was reasonable in that case.[12]

The lessons in these cases are several-fold. First, courts increasingly are reluctant to summarily strike down agreements with nationwide, or even worldwide, noncompete restrictions if, under the facts of the particular case, the employee's responsibilities and the employer's business justify the scope of the restriction. Second, it is helpful in these kinds of cases for the contract itself to set forth the scope of the employee's duties and the justification for the scope of the noncompete restriction. Employers are advised not to rely simply on the evidence to support these interests when they can be recited, and acknowledged, by the employee in connection with a description of the employee's job responsibilities and/or the nature of the company's business. It remains important, of course, to be cognizant of the laws of the particular state that might apply, as the holdings of the cases identified above are not suggested to be of persuasive authority in every state.

IV. Alternatives to Traditional Restrictive Covenants to Deter Unfair Competition

Given the difficulty of obtaining injunctive relief to enforce covenants not to compete, as well as the unpredictability associated with conflicting state laws, some employers have sought creative, if more conservative, methods to protect top talent and prevent unfair competition. One such method is through agreements that condition compensation, typically in the form of stock options or bonus payments, on compliance with postemployment restrictive covenants. These so-called ''forfeiture'' agreements require the employee to repay all or a portion of stock proceeds or bonus compensation if he or she violates the terms of a noncompete covenant.

Courts almost uniformly have upheld these kinds of agreements, even in cases in which an underlying noncompete covenant was held to be unenforceable. An example of such a case is *Olander v. Compass Bank*,[13] Olander was a former vice president of Compass Bank and entered into several stock option agreements that contained covenants not to compete as well as a ''clawback'' provision requiring the former executive to repay the profits on stock sales in the event a court declared the noncompete clause unenforceable. Applying the Texas rule that an employer's consideration in a noncompete agreement must create a legitimate interest in restraining competition, and finding that the stock options provided to the executive did not create such an interest, the federal Fifth Circuit Court of Appeals struck down as unenforceable the noncompete terms of the parties' agreement. The court, however, ordered that the employee return nearly $225,000 in profits from the stock option agreements. It expressly found that the lawfulness of the underlying noncompete agreement was irrelevant to the analysis of the contractual promise to return the profits from the stock. Accordingly, while the court did not enforce the noncompete agreement per se, it did require repayment of the stock proceeds.

Other courts similarly have enforced agreements that require forfeiture of previous benefits without regard to the reasonableness or enforceability of underlying noncompete terms. For example, in *Viad Corp. v. Houghton*,[14] the court upheld an agreement that required the employee to repay previous bonuses earned under a management incentive plan. The court, citing other federal decisions, ruled that a forfeiture–for-competition clause in an employment agreement is enforceable without regard to the reasonableness of the restraint on the former employee. While acknowledging a possible distinction between the forfeiture of a ''bonus'' like a stock option and ''regular compensation'' such as wages and commissions, the court held that the requirement to repay bonuses paid under the management incentive plan was not unreasonable.[15]

The obvious downside for employers to these types of forfeiture agreements is that they may not provide sufficient incentive to deter unfair competition. For example, the subsequent employer of an executive may simply pay the executive the amount of the required forfeiture to entice him or her to join its employment or,

[11] 631 F. Supp. 2d 705 (M.D.N.C. 2009).

[12] See also *Universal Engraving, Inc. v. Duarte*, 519 F. Supp. 2d 1140 (D. Kan. 2007) (finding that a universal noncompete agreement was not patently unreasonable in the context of an employee who performed duties worldwide, conducted worldwide research and development, and had customer relations worldwide, and where the employer's information could be utilized ''through using a computer to transport the information, thus giving the information an easy route to travel world-wide, even if [the employee] did not move to another country''). *The Estee Lauder Cos. v. Batra*, 430 F. Supp. 2d 158 (S.D.N.Y. 2006) (upholding worldwide noncompete agreement given the universal responsibilities of the employee and the international scope of the cosmetic industry in general where the employee was paid his salary for the duration of a 12-month noncompete period). But see *Harper/Love Adhesives Corp. v. Van Witzenberg*, 2008 U.S. Dist. LEXIS 21489 (N.D. Ind. 2008) (assessing noncompete agreement with no geographic restrictions that essentially prohibited competition in the entire Western Hemisphere plus Europe and found that the employer failed to present an adequate justification under North Carolina law for prohibiting the employee from engaging in any direct or indirect competition).

[13] 363 F.3d 560 (5th Cir. 2004).

[14] No. 08-cv-6706 2010 U.S. Dist. LEXIS 17447 (N.D. Ill. Feb. 26, 2010).

[15] See also *Clark v. Lauren Young Tire Ctr. Profit Sharing Trust*, 816 F.2d 480, 482 (9th Cir. 1987) (''[A] noncompetition forfeiture clause in a pension plan is not like a noncompetition agreement in the employment context, which may unreasonably restrain trade or endanger the employee's livelihood.''); *Schlumberger Tech. Corp. v. Blaker*, 859 F.2d 512, 516 (7th Cir. 1988) (noting that the ''majority of states enforce . . . forfeiture clauses'' calling for the forfeiture of benefits such as ''severance pay, stock options, bonuses, pension, and the like'' in the event of prohibited competition).

  ISSN

similarly, may provide a sufficiently attractive compensation plan to the extent that he or she is willing to accept the risks of forfeiture.

One issue not resolved in the case law is whether an employer can contract to a forfeiture of previously paid benefits while retaining the right to seek injunctive relief. Election of remedies rules typically might require an employer to choose between injunctive relief or enforcement of a monetary penalty clause. Indeed, many courts might find the existence of the penalty clause as a bar to injunctive relief under the theory that such a clause is proof of the absence of irreparable harm. Still, there may be creative ways to contract around these legal obstacles by including clauses in noncompete agreements whereby the parties agree to the nonapplication of election of remedies or expressly authorize injunctive relief in addition to forfeiture of benefits in the event of breach. Of course, any attempt to enforce a noncompete agreement through injunctive relief would require compliance with state law, which the forfeiture agreements may be designed to avoid in the first place. Nonetheless, the former executive who faces both the prospects of losing previously paid compensation and being judicially barred from competitive activity may be doubly deterred from violating the terms of a noncompete agreement.