Across the Board: Changes Are in the Works for Noncompete Agreements

By A. Michael Weber

From coast to coast, changes are in progress in state laws governing the enforcement of noncompete agreements. In New York, the "employee choice" doctrine shows continuing vitality, while in Oregon, the circumstances under which courts will enforce noncompete agreements are becoming more narrow. The Texas Supreme Court recently clarified its stance on the use of forum-selection clauses in noncompete agreements, proving the west is not so wild after all. In 2007, courts and state legislatures were taking action to specify when and under what circumstances noncompete agreements will be enforced. Employers would be wise to take heed of these changes, evaluate their current use of noncompete provisions, and consult counsel appropriately.

A "Constructive" Decision: The Employee Choice Doctrine Is Alive and Well in New York

Employers frequently condition the payment of post-employment compensation on an employee's compliance with a restrictive covenant, such as a noncompete agreement. For example, many deferred compensation plans provide that an employee who resigns and goes to work for a competitor automatically forfeits any nonvested deferred compensation. Such provisions have long been enforceable in New York under the "employee choice" doctrine, which holds that an employee who chooses to resign and violate his or her noncompetition obligations can be deemed to have waived any legal right to such compensation - regardless of whether the noncompete agreement is reasonable. This doctrine is based on the notion that the employee is effectively given a choice to either preserve his right to such compensation by refraining from engaging in competitive employment, or lose that right if he chooses to resign and compete with his former employer. Conversely, if the *employer* terminates the employment relationship without cause, no forfeiture may be imposed because the employee is essentially deprived of the opportunity to make a choice.

The New York Court of Appeals' recent decision in *Morris v. Schroder Capital Management*, 2006 N.Y. Slip Op 08638, has made it significantly more difficult for employees to challenge forfeiture provisions linked to restrictive covenants. The plaintiff in *Morris* was employed as Senior Vice President and head of domestic equities at Schroder Capital ("Schroder"). A portion of his annual year-end bonus was deemed a "deferred compensation award," which did not vest until three years after the date of issue. The company's deferred compensation plan expressly provided that if an employee resigned and accepted employment with a competitor prior to the end of the three-year vesting period, all nonvested deferred compensation would be forfeited. When Morris resigned to open a hedge fund in competition with Schroder, he was notified that his deferred compensation was deemed forfeited.

Morris sued for breach of contract, claiming that Schroder had forced him to resign by significantly diminishing his job responsibilities. Specifically, Morris claimed that the company had reduced the amount of investment assets over which he had control from $7.5 billion to $1.5 billion. Morris argued that the standard for determining whether a resignation was voluntary or involuntary for forfeiture purposes should be whether the

employer "was willing to employ the employee in the same or comparable job" for which he was hired. The trial court disagreed, holding that an employee who resigns and seeks to avoid forfeiture must satisfy the same stringent "constructive discharge" standard applied by federal courts in employment discrimination cases where the voluntary nature of the termination is in dispute. To establish a constructive discharge, an employee must prove that the employer deliberately made his or her working conditions so intolerable that a reasonable person in the employee's situation would have felt compelled to resign. Typically, actions such as a demotion, failure to promote, transfer, or change in assignments are not sufficient to establish a constructive discharge. The Court of Appeals in *Morris* upheld the trial court's application of the constructive discharge standard, and held that Morris's mere dissatisfaction with the change in his job responsibilities did not render his resignation "involuntary". As such, the employee choice doctrine controlled, and the forfeiture provision in Schroder's deferred compensation plan was deemed valid and enforceable it was applied to Morris.

The *Morris* decision significantly raises the bar for employees seeking to violate post-employment restrictive covenants without forfeiting their nonvested compensation and benefits. By requiring such employees to overcome the higher hurdle of establishing a constructive discharge, the Court of Appeals has clearly signaled that the employee choice doctrine is alive and well in New York.

Forum Selection Clauses in Texas-*Location, Location, Location*

Texas has a strong public policy on noncompete contracts but after the Texas Supreme Court's decision in *AutoNation* on June 29, 2007, Texas residents cannot be assured that they will be able to keep a dispute over a noncompete contract in a Texas courtroom. The Texas Supreme Court has made it clear that because of the important public policy concerns regarding noncompetition covenants, Texas law will apply to an employee who performs the majority of services in Texas, even when the parties stipulate the law of a different forum. Thus, even if a contract says that another state's law will control, the Texas public policy will overrule the contract language and result in Texas law applying.

What happens, however, with regard to the location of legal dispute? If the contract says the court of a different state (like Florida) is the exclusive forum for a legal battle over the noncompete contract, will that contract provision be honored? Or, will Texas public policy not only overrule the choice of law clause but also overrule the choice of forum clause as well? The answer may depend on who gets to the courthouse first, but more likely than not, the contract's choice of forum will be honored.

Despite the strong state public policy interest in covenants not to compete, Texas courts have repeatedly enforced forum selection clauses where the parties have agreed to litigate the question of a noncompetition provision in another state. Therefore, the initial decision of the Texas Court of Appeals in *AutoNation, Inc. v. Hatfield*, was somewhat surprising.

In *AutoNation*, the employee, Hatfield, who worked at a Mercedes-Benz dealership in Houston, Texas, owned by AutoNation, signed a noncompete agreement that contained a provision requiring any lawsuits to be filed in Florida. After the employee resigned and

accepted employment with a competing Mercedes-Benz dealership, A-Rod OC, LP ("A-Rod") (a dealership owned by Alex Rodriguez, who formerly played for the Texas Rangers and may continue to play for the Yankees next year), AutoNation filed suit in Florida for breach of the agreement. Before learning of the Florida suit, Hatfield and A-Rod filed a declaratory judgment action in Texas and sought injunctive relief. After learning of the Florida suit, Hatfield and A-Rod sought an injunction against AutoNation proceeding with the suit in Florida. The Texas trial court issued a temporary injunction restraining AutoNation from taking any further action in the Florida suit and from filing any future litigation in any non-Texas court seeking to enforce the restrictive covenants. AutoNation filed an accelerated appeal and the Texas court of appeals affirmed the issuance of the injunction. In so doing, the court of appeals recognized a general public policy against enjoining suits in other states, but noted that the issue of whether noncompete agreements are reasonable restraints upon Texas employees is a matter of fundamental Texas public policy.

Not to be deterred, AutoNation then filed a writ of mandamus challenging the order granting a temporary injunction, which was denied by the Houston Court of Appeals. The ever-persistent employer then petitioned for a writ of mandamus from the Texas Supreme Court.

The Texas Supreme Court conditionally granted AutoNation a writ of mandamus and directed the trial court to dismiss Hatfield and A-Rod's suit in favor of the first-filed Florida litigation. *In re AutoNation, Inc.*, 2007 Tex. LEXIS 604, 50 Tex. Sup. J. 960 (Tex. June 29, 2007). The court recognized that it had previously held that the enforcement of noncompete agreements was a matter of Texas public policy, but stated that it "decline[d] Hatfield's invitation to superimpose the ...choice-of-law analysis onto the law governing forum-selection clauses." The court further declared that "we have never declared that fundamental Texas policy requires that every employment dispute with a Texas resident be litigated in Texas."

The court went on to note that giving deference to the first-filed Florida litigation, not only complied with the agreed-upon contract terms, but honored principles of interstate comity, whereby one state or jurisdiction will give effect to the laws and judicial decisions of another. When a matter is first filed in another state, Texas courts will generally stay the later-filed proceeding pending resolution of the first suit. "Accordingly, and without offending *DeSantis*, we will not presume to tell the forty-nine other states that they cannot hear a noncompete case involving a Texas resident-employee and decide what law applies, particularly where the parties voluntarily agree to litigate enforceability disputes there and not here."

The end result is that the party that won the race to the courthouse is the one who got to control the venue of the litigation. Employers should note that this is a different result from what has been seen in other state courts in the recent past.

The take-away from *In re AutoNation* is that employers who use noncompete contracts should have their contracts reviewed to ascertain whether they currently contain forum-selection clauses. If not, employers should evaluate whether to implement such provisions. And, if the contracts already contain forum-selection clauses, employers should ascertain whether having

disputes litigated in the designated-forum state is still a good decision. With the Texas Supreme Court's recent pronouncement in *Sheshunoff Management Services, L.P. v. Johnson,* noncompete agreements are easier to enforce under Texas law (and, likewise, in Texas courts). Depending on the circumstances, employers may be well-served, post-*Sheshunoff,* to include forum-selection clauses choosing Texas as the forum state.

Chicago Title Insurance Corporation v. Magnuson, et al.: A Case Against Employee Raiding

First American embarked on a strategy to expand its business; and a part of the strategy apparently included efforts to recruit qualified individuals from competing companies. First American contacted James Magnuson at a competing employer Chicago Title - despite his noncom Pete agreement. Indeed, First American offered Magnuson full indemnity on the noncompete agreement. Along with Magnuson, First American also began recruiting other key Chicago Title employees (and customers) from central Ohio. Ultimately 30 employees left.

Chicago Title responded by suing for breach of contract, tortious interference, and a variety of other claims. Ultimately, after the district court granted Chicago Title's motion for summary judgment on certain issues, the court sent the question of damages to the jury. The jury returned a verdict of $10.8 million in compensatory damages, and a whopping $ 32.4 million in punitive damages, against the defendants.

On appeal, the Sixth Circuit also held that Chicago Title did have an interest in employee and customer relationships worthy of protection in the marketplace, and that First American's practice of employee raiding infringed on those interests.

First American also challenged the award of punitive and compensatory damages, arguing that a punitive damage award was inappropriate in this case, and that compensatory damages on Chicago Title's lost volume seller claim were also inappropriate. Here, the Sixth Circuit agreed, holding that First American's conduct was not sufficiently reprehensible to support an award of punitive damages in this case. Specifically, the Sixth Circuit noted that while First American acted with malice, there were no physical injuries or threats to personal safety as a result of the company's conduct, and malice alone was not enough to support a punitive damages award. Thus, while the motions for summary judgment as to the primary causes of action were upheld, the Sixth Circuit ordered a new trial on compensatory damages consistent with its opinion, and threw out the punitive damages claim altogether.

Oregon Takes a Hard (and More Complex) Stance on Noncompetes

Currently awaiting signature by Oregon's Governor is Senate Bill 248, which has been passed by both the Oregon Senate and House of Representatives. The bill, which amends Oregon Revised Statute 653.295 (and 36.620, pertaining to arbitration agreements) proposes sweeping changes to Oregon's law on noncompete agreements. Under the new law, a noncompete in the employment context is voidable and may not be enforced by an Oregon court unless:

1. The employer informs the employee at least two weeks before the first day of the employee's employment that a noncompetition provision is required as a condition

of employment *or* the noncompete agreement is entered into upon a bona fide advancement of the employee by the employer;
2. The employee is engaged in administrative, executive or professional work and performs predominantly intellectual, managerial, or creative tasks, exercises discretion and independent judgment, and earns a salary or is otherwise exempt from Oregon's minimum wage and overtime laws;
3. The employer has a "protectable interest" (meaning, the employee has access to trade secrets or competitively sensitive confidential business or professional information or is an on-air talent);
4. The total amount of the employee's annual gross salary and commission, calculated on an annual basis, at the time of the employee's termination, exceeds the median family income for a family of four, as determined by the United States Census Bureau (this provision is not applicable to on-air talent); and
5. The term of the noncompete does not exceed two years from the date of the employee's termination. Any portion of a noncompetition term in excess of two years is voidable and will not be enforced.

The Act contains a savings provision that allows employers to keep a noncompete agreement in place for employees who are nonexempt or paid wages below median family income (thus failing the requirements 2 and/or 4 above by paying the employee during the period of time the employee is restrained from competing. Under this savings clause provision, if the employer provides the employee, for the time the employee is restricted from working, the greater of: (a) compensation equal to 50% of the employee's salary and commissions; or (b) 50% of the median income for a family of four (as determined by the United States Census), then failure to meet requirements 2 and/or 4 will not cause the noncompete agreement to become unenforceable.

The Act's requirements do not apply to "bonus restriction agreements." "Bonus restriction agreements" are defined by the Act as agreements between employers and employees whereby competition of the employee is limited post-employment and the penalty imposed on the employee for competition against the employer is forfeiture of profit sharing or other bonus compensation that has not yet been paid to the employee.

The Act also does not apply to customer or employee nonsolicitation provisions.

Conclusion

The activity this past year should remind employers that the level of regulation when it comes to covenants not to compete and related agreements can vary from industry to industry and from state to state. At the top of every employer's list of New Year's resolutions for 2008 should be a commitment to evaluate their current use of such agreements.

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