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Mouse-Proofing Noncompetes

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"[O]ne … employer … appears to have found a way to ensure the enforceability of covenants not to compete in stock option agreements."

"Heads I win, tails you lose."

Everyone loves a sure bet, and one clever employer (or, more likely, one employer's clever attorney) appears to have found a way to ensure the enforceability of covenants not to compete in stock option agreements. Well, actually, the employer did not so much find a way to prevent an executive from competing as it found a way to recover options granted to an executive who does so. This creative employer's ingenuity bore fruit when the federal Circuit Court of Appeals for the Fifth Circuit (which hears appeals from federal trial courts in the states of Louisiana, Mississippi, and Texas) permitted the employer to recover stock option compensation from a former executive by reason of the executive's competitive activities, even though the agreement's prohibition on competition was itself unenforceable. That is, the employer was able to recover option compensation it had conditioned on noncompetition even though the employer could not have obtained an injunction prohibiting the former executive from engaging in the listed competitive activities. The result was that the former executive had a legal right to compete, but had to repay almost $225,000 in stock option compensation he had received on the condition that he not compete. The Fifth Circuit reached this conclusion in *Olander v. Compass Bank*, 363 F.3d 560 (5th Cir. 2004).

All employers with multi-state operations should consider the lesson of the *Olander* decision. That is because a persistent worry for multi-state employers is the difficulty in enforcing uniform noncompete provisions, given the difference in standards the states apply in determining the validity of such prohibitions. Some states, like New York, make it easier to enforce noncompetes if all the employer wants is to avoid the need to pay severance, stock options, or other forms of compensation to a departed executive. In these states, even if an employer may not actually prevent a former executive from competing (for example, by getting an injunction prohibiting the former executive's competitive activities), it might still be able to avoid paying the former executive certain types of compensation or be able to recover compensation already paid. The *Olander* decision offers a recipe for achieving this same result in other states.

In *Olander*, an executive was, under the terms of separate, annual stock option agreements, prohibited from engaging in certain competitive activities for two years after his termination of employment. The agreements barred the executive from soliciting existing customers, enticing employees to leave their jobs, and divulging trade secrets, customer lists, or other confidential information.

The special twist in these agreements was the inclusion of a provision the court termed "remarkable," under which if the noncompete provisions were held by a court to be invalid or unenforceable for any reason in a lawsuit between the executive and the employer, the employer was entitled to have returned to it all stock held by the executive. If the executive had already sold stock obtained through an option exercise, the employer was instead entitled to receive from the executive the bargain element the executive enjoyed upon exercise, as well as any profit from the increase in value of the stock after exercise and before the executive sold the shares.

The executive in *Olander* had grown dissatisfied with his job and resigned to begin work with a direct competitor. Before leaving to do so the executive exercised his right to stock options under six different annual agreements and then immediately filed a declaratory judgment action in state court to have certain of the noncompetes declared unenforceable. The employer removed the lawsuit to federal court and asked for a preliminary injunction against the executive, which was denied.

The Fifth Circuit agreed with the federal trial court that the noncompete provisions were unenforceable under Texas law. That was because for a noncompete to be enforceable under Texas law the agreement must be "ancillary to or part of an otherwise enforceable agreement at the time the agreement is made." This means, in part, that there must be some "consideration" the employer gives in exchange for the employee agreeing not to compete. The court found that the employer in fact gave no consideration in exchange for the noncompete. Although the executive was promised stock options, the court considered this promise "illusory," and therefore incapable of constituting the consideration necessary to make a contract valid. The promise to pay option compensation was illusory because the executive was an at-will employee who could be fired at any time, and under the terms of the option agreement the executive's options would terminate when employment terminated. This meant the employer could have, at any time, taken away what it was giving in exchange for the noncompete – the stock options – by terminating the executive.

"If an employer only wants the ability to condition the payment of compensation on an executive not competing, the employer should consider … requiring [the] executive to repay [the] compensation if the agreement's noncompete is determined to be invalid …."

Although the noncompete was unenforceable, the court did enforce the provisions requiring the executive to return the option compensation paid to him, since that compensation had been conditioned on the executive not competing. If the other federal circuit courts of appeal adopt the reasoning of the Fifth Circuit in Olander, employers can have confidence in their ability to condition the payment of options (or, presumably, other executive compensation) on an executive not competing. Under Olander, if an employer simply wants to condition the payment of compensation on an executive not competing, as opposed to being able to enjoin the executive from competing, the employer can impose a broader noncompete than would normally be enforceable.

Lessons

1. Employers should consider whether they want to condition stock options, or other executive compensation, on a former executive not competing.

2. If an employer wishes to do so, it should consider whether it is important to actually prohibit competition (and be able to obtain an injunction prohibiting an executive from competing) or whether the employer instead wants simply to avoid the payment of compensation (or recover compensation already paid) should an executive compete.

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3. If an employer only wants the ability to condition the payment of compensation on an executive not competing, the employer should consider including in its option agreements, and possibly in other executive compensation programs, the type of "fail safe" provision included in *Olander* – that is, requiring an executive to repay compensation if the agreement's noncompete is determined to be invalid or unenforceable.

4. Employers should consider whether to modify *existing* option (or other executive compensation) agreements to require the repayment of compensation where a noncompete is determined to be invalid or unenforceable. If an employer wishes to do so, it will need to carefully consider the existing agreements' provisions concerning when and to what extent the agreements can be amended, and will need to comply with any constraints found in those provisions, such as any requirement that employees consent. An employer should probably also assume it will need to provide consideration to executives for the modification (that is, an employer may need to give executives something of value in exchange for their agreeing to repay compensation in the event the noncompete is determined to be invalid or unenforceable).

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