CHOICE-OF-LAW PROVISIONS AND THE ROLE OF BUSINESS RELATIONSHIPS TO OTHER JURISDICTIONS WITH RESPECT TO DETRIMENTAL-ACTIVITY CLAUSES IN EXECUTIVE COMPENSATION PLANS

By Allen Bywaters Landon*

Exxon Mobil Corp. v. Drennen, 452 S.W.3d 319 (Tex. 2014).

In *Exxon Mobil Corp. v. Drennan*, the Supreme Court of Texas reversed the court of appeals' judgment in favor of a former executive, William Drennan, III, ("Drennan") and rendered a judgment for Exxon Mobil ("Exxon").[1] The dispute between the parties arose from an executive compensation plan, which included a contractual choice-of-law provision designating that New York law would apply as well as a provision for forfeiture of the executive's bonus awards in the event he engaged in "detrimental activity."[2] The Court concluded that Exxon's basis for choosing New York law, the goal of uniformity, was logical[3] and reasonable,[4] both Texas and New York bear some relationship to the parties and the transaction,[5] the forfeiture provision was not a covenant not to compete,[6] and that, under Texas law, application of New York law would not contravene Texas policy;[7] thus, the Court was bound to enforce the contractual choice-of-law provision and apply New York Law.[8] New York permits enforcement of similar detrimental-activity provisions to employment contracts, so the provision would be enforced without regard to whether Texas law would permit such.[9]

I. Background.

Mr. Drennen was an employee of Exxon for approximately thirty one years spanning from 1976 to 2007.[10] Drennen's work throughout his career with Exxon was as a geologist and his final title before retirement was Exploration Vice President of the Americas.[11] During his employment with Exxon, Drennen signed incentive compensation programs in 1993 and 2003, and these programs awarded bonuses, restricted stock options, and earnings bonus units.[12] Both parties executed the incentive program agreements in Texas.[13] Each of the program agreements included choice-of-law provisions indicating New York law would apply, and termination provisions enabling Exxon to "terminate outstanding incentive awards if the employee (1) engaged in a detrimental activity, or (2) left" Exxon by resignation or abnormal

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1 Exxon Mobil Corp. v. Drennen, 452 S.W.3d 319, 332 (Tex. 2014).

2 *Id.* at 321.

3 *Id.* at 332.

4 *Id.* at 325.

5 *Id.* at 324.

6 *Id.* at 329.

7 *Id.* at 330.

8 *Id.* at 331.

9 *Id.* at 332.

10 *Id.* at 322.

11 *Id.*

12 *Id.*

13 *Id.*

form of termination.[14] The programs further defined detrimental activity in 1993 as "activity that is determined in individual cases by the administrative authority to be detrimental to the interest of the Corporation of any affiliate," and in 2003 as "acceptance . . . of duties to a third party under circumstances that create a material conflict of interest" including when the recipient becomes employed by an entity that "regulates, deals with, or competes with" Exxon or its affiliates.[15]

After receiving an unfavorable annual performance review in the midst of a new C.E.O.'s push to promote younger vice presidents, Drennen learned from his supervisor, Tim Cejka, that "so long as he did not go to work for one of the other four "majors" (Shell, BP, ChevronTexaco, or ConocoPhilips), he would [not lose his unvested options]" should Drennen leave Exxon.[16] The next year, after already receiving 16,700 shares of unrestricted stock and cashing out $4 million in pension funds, $1.8 million in 401(k) funds, and $3 million in stock options throughout his employment to that point, Drennen retired from Exxon with 57,200 shares still held within their restriction period.[17] Despite being warned by Cejka that if he took a position with Hess Corporation he would likely lose all his remaining incentives, Drennen began working at Hess as Senior Vice President for Global Exploration and New Ventures in July 2007.[18] Soon after, Cejka notified Drennen of cancellation of his remaining incentive awards due to the fact Hess is a direct competitor of Exxon, constituting a material conflict of interest or "detrimental activity" under both incentive plans.[19]

Drennen sued to recover the stock Exxon claimed he forfeited, seeking judgment that:

> (1) the detrimental-activity provisions in the Incentive Programs were being utilized as covenants not to compete; (2) the covenants not to compete are unenforceable because they are not limited as to time, geographic area, or scope of activity; and (3) therefore, ExxonMobil's cancellation of the restricted shares and bonus units was an impermissible attempt to recover monetary damages for an alleged breach of an unenforceable covenant not to compete.[20]

Drennen also claimed breach of oral contract regarding the earlier conversation with Cjeka that Drennen could retain awards as long as he did not work for one of the four majors, asserted the written program agreements had been modified by this oral statement, and raised an estoppel or waiver argument based on the assertion by Cjeka.[21] The jury found for Exxon on all claims, so Drennen moved for judgment notwithstanding the verdict ("JNOV"), which was denied by the trial court.[22]

Following denial of the JNOV, Drennen appealed arguing Texas public policy prohibits

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[14] *Drennen*, 452 S.W.3d at 322.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 323.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*

enforcement of detrimental-activity provisions because they constitute void covenants not to compete.[23] The 14th District Court of Appeals reversed and ordered the trial court to render a declaratory judgment for Drennen, holding that the forfeiture provisions were unreasonable covenants not to compete and thus unenforceable under Texas law as a matter of public policy.[24] Because applying New York law would lead to a result against Texas public policy, the Court of Appeals found the choice-of-law provision unenforceable; therefore, Texas law applied and the detrimental-activity provisions were unenforceable.[25]

II. Texas Supreme Court Analysis.

After Exxon appealed to the Supreme Court of Texas, the Court applied an analysis modeled after the Restatement (Second) Conflict of Laws,[26] which involved considering the enforceability of the choice-of-law provisions by investigating whether New York had a sufficiently close relationship to the parties and the contract to make the choice of New York law reasonable,[27] whether Texas or New York had the more significant relationship to the parties and the contract,[28] which state had a materially greater interest in the matter,[29] and whether the application of New York law would be contrary to a fundamental policy of Texas.[30] This analysis was similarly used in 1990 by the Court in *Desantis v. Wackenhut Corp*.[31] After noting that Texas law recognizes that parties can agree to be governed by the law of another state,[32] the Court indicated that parties' choice of such law must have some "sufficiently close" relation to the parties and their agreement to render the choice reasonable.[33] The Court also indicated that the other potential reason to void a choice-of-law provision would be if application of that law is contrary to fundamental policy of a state with a materially greater interest than the state chosen.[34]

Drennen worked in Houston when each of the incentive program agreements were signed,

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[23] *Drennen*, 452 S.W.3d at 323.

[24] *Id.*

[25] *Id.* at 323–24.

[26] The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice,

or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of applicable law in the absence of an effective choice of law by the parties.

RESTATEMENT (SECOND) CONFLICT OF LAWS § 187(2) (1971).

[27] *Drennen*, 452 S.W.3d at 324–25 (Tex. 2014).

[28] *Id.* at 325–26.

[29] *Id.* at 326–27.

[30] *Id.* at 327–30.

[31] *Id.* at 324. *See also* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 677 (Tex. 1990).

[32] *Drennen*, 452 S.W.3d at 324.

[33] *Id.* at 324–25.

[34] *Id.* at 325.

but during his time working for Exxon he also spent three years working in New York City.[35] Exxon is headquartered in Texas, but their outside counsel is a firm in New York City and the shares in question are traded on the New York Stock Exchange ("NYSE") in New York City.[36] Exxon claimed choosing New York law was reasonable on the basis of assuring uniformity, certainty, and predictability in the application of its incentive programs; because such awards are provided to numerous employees in multiple places throughout the United States and the world, there is a good likelihood for those employees to relocate throughout their careers.[37] Additionally, the stock which is the subject of the incentives is listed on the NYSE.[38] New York law regarding employee stock incentive programs is well-developed and predictable, "making it a routine choice of law for parties to stock-related transactions and agreements."[39] Considering the above facts and arguments as well as the low likelihood parties would designate such a provision without reason, the Court concluded that the choice of New York law was enforceable.[40]

The next *DeSantis* consideration the Court applied was whether, absent an effective choice-of-law, there is a state with a more significant relationship to the parties and the transaction than New York.[41] To make this determination, the Court factored the location of the execution of the agreement, the locations of the parties, the location of negotiations, and the place of performance.[42] The agreements were both executed in Texas, both parties are located in Texas, and the negotiations as well as performance of the contract took place in Houston and Irving, Texas.[43] Comparatively, Drennen did work for three years in New York and Exxon has a presence in New York.[44] The Court indicated that the parties and the transaction bear relations to both states, but after considering the interests the Court concluded that Texas has a more significant relationship.[45]

The Court then analyzed whether Texas has a materially greater interest in determining the enforceability of detrimental activity provisions, because if it does not have a greater interest then it is immaterial whether New York law application is contrary to fundamental Texas policy.[46] In *DeSantis*, the Court held that Texas clearly had a materially greater interest in whether the agreement should be enforced, because the plaintiff was an employee in Texas, the defendant was a national employer doing business in Texas, the plaintiff formed a new business in Texas in violation of a non-compete provision, and Texas was concerned with how non-compete agreements affected consumers of services in Texas.[47] Exxon argued that Texas has no materially greater interest than New York in enforceability, because the choice-of-law

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35 *Drennen*, 452 S.W.3d at 324.

36 *Id.*

37 *Id.* at 325.

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* at 325–26.

42 *Id.* at 326.

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*

47 *Drennen*, 452 S.W.3d at 326.

provision was made for uniformity and predictability.[48] That argument failed, because despite there being interests in protecting justifiable expectations of entities doing business in multiple states, those external interests do not outweigh Texas's.[49] Additionally, the *DeSantis* employer was Floridian, but the Court concluded Texas had a materially greater interest, so in this case where both parties were Texas residents the Court indicated it must favor Texas over New York for such interest.[50]

The last step in the Court's analysis was to determine whether fundamental policy of Texas would disfavor applying New York law.[51] Without defining "fundamental policy," the Court indicated that it would be necessary to "determine whether the provisions at issue in the [i]ncentive [p]rograms are covenants not to compete."[52] Texas generally defines covenants not to compete as obligations that limit former employees' work mobility or restrict solicitation of former customers, which are trade restraints governed by the Covenants Not to Compete Act.[53] The incentive program agreements did not limit the professional mobility of Drennen *per se*, so the Court indicated the agreements in question did not "fit the mold."[54]

A narrow but important difference was present: non-competition provisions protect the investment of an employer in an employee, while forfeiture provisions conditioned on loyalty reward that loyalty but do not restrict employee future employment.[55] Furthermore, a former employer can file suit for breach of contract to enforce a non-competition clause, but a former employer does not have to take any legal action under a forfeiture provision, because the employer owns the profit-sharing plan.[56] The detrimental activity provisions in the incentive programs were deemed different from non-competition provisions in key Texas non-competition cases, such as *DeSantis*.[57] Drennen agreed that he would receive bonus compensation for his hard work in the form of stock, not that he would refrain from soliciting clients or employees or not compete with Exxon all-together.[58] This agreement between Drennen and Exxon carried a condition of continued loyalty, which empowered Exxon to withhold restricted shares of bonus compensation if the employee chose to compete during the restricted phase period.[59] Instead of contracting that Drennen not compete, the incentive program agreements only force the employee to choose between accepting his retirement plan benefits he contributed nothing to or choose to compete with the former employer.[60] The Court therefore held that forfeiture clauses such as those present in the Exxon incentive plans are not covenants not to compete.[61]

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48 *Id.*

49 *Id.* at 326–27.

50 *Id.* at 327.

51 *Id.*

52 *Id.*

53 *Id.*

54 *Id.*

55 *Id.* at 327–28.

56 *Id.* at 328.

57 *Id.* at 328–29.

58 *Id.* at 329.

59 *Id.*

60 *Drennen*, 452 S.W.3d at 329.

61 *Id.*

The Court next turned its focus to public policy and conflict of laws by indicating that the policy concerns over uniformity of law in the *DeSantis* case time have changed over the past few decades.[62] Since Texas hosts many large corporations, its public policy has shifted to value the ability of a company to maintain uniform treatment of its employment contracts regardless of where the employees reside.[63] Such policy "prevents the disruption of orderly employer-employee relations . . . and avoids disruption to competition in the marketplace."[64] Given the scope and size of Exxon, the Court concluded that even if application of Texas or New York law were to reach different results on enforceability, it was not likely to constitute a determination contrary to fundamental Texas policy.[65] Furthermore, Texas will not refrain from applying a chosen law simply on the basis that the result would be different from an application of state law or otherwise applicable law.[66] The Court indicated it was bound to enforce the parties' choice-of-law provisions, because enforcement of New York law would not contravene Texas fundamental public policy.[67]

After concluding its analysis of enforceability of choice-of-law provisions and forfeiture provisions such as those found in the Exxon agreements, the Court considered the application of New York law to the facts of the case at hand.[68] A very similar case to *Exxon*, *Morris v. Schroeder Capital Management International*, was reviewed.[69] When a provision leaves the receipt of incentive rewards up to a choice of an employee, whether he chooses to not compete and receive the benefits or compete and decline the benefits, it is not an unreasonable restraint upon his ability to earn a living or his liberty.[70] Drennen agreed to the detrimental activity provisions in exchange for the compensation program benefits, and the provisions did not bar him from working elsewhere.[71] The detrimental activity provisions of the incentive programs gave Drennen the choice to preserve his right to the remaining 57,200 shares by complying or risk forfeiture of his rights by choosing to exercise his right to compete with Exxon.[72]

The Court indicated that if Exxon had terminated Drennen's employment without cause, then enforcement of the detrimental activity provisions would not be reasonable.[73] If Drennen voluntarily left or was terminated for cause, then the covenants would be enforceable regardless of reasonability and choice.[74] Drennen was told his performance was inadequate to continue his current position with Exxon, but the company would find another position for him.[75] Drennen then retired, "made an informed choice" to forfeit his outstanding awards by accepting employment with a competing company rather than retaining his awards by avoiding

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62 *Id.*

63 *Id.* at 330.

64 *Id.*

65 *Id.*

66 *Id.* at 331.

67 *Id.*

68 *Id.* at 331–32.

69 *Id.* at 331. *See also* Morris v. Schroeder Capital Management International, 859 N.E.2d 503 (N.Y. 2006).

70 *Drennen*, 452 S.W.3d. at 331.

71 *Id.* at 332.

72 *Id.*

73 *Id.*

74 *Drennen*, 452 S.W.3d at 332.

75 *Id.*

competition, and under New York law Exxon lawfully terminated Drennen's outstanding awards upon breach.[76]

III. Conclusion.

The Court reversed the court of appeals' judgment and applied New York law to reach its judgment for Exxon.[77] Its rationale was that uniformity is a logical basis for Exxon's choice of New York law as well as a valid goal the Restatement (Second) of Conflict of Laws §187 recognizes.[78]

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[76] *Id.*

[77] *Id.*

[78] *Id.*