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Wisconsin Court of Appeals Addresses Enforceability of Covenants Not to Compete Entered Into as Part of Stock Option Agreements

In Wisconsin (and the same is true in most states) there are two sets rules for interpreting non-competition agreements: one set of rules for agreements incident to the sale of a business, and one set for most other agreements. Courts permit great latitude in enforcing agreements incident to the sale of a business, but are very strict and inflexible in interpreting most other agreements. In many cases, whether an agreement is valid, or not, depends on which rules apply. On July 13, 2010, the Wisconsin Court of Appeals decided the case of *Selmer Co. v. Rinn,* in which the court upheld a restrictive covenant procured by Selmer Co. from an employee because the covenant was obtained without consequence to the employee's job status. The court upheld a covenant not to compete that was part of a stock option agreement that the employee had signed while still employed by Selmer. The case is significant because the court made clear that Wisconsin Statutes Section 103.465, which normally requires Wisconsin Courts to carefully scrutinize such covenants in the employment context, did not apply to the covenant in question.

The application of Section 103.465 is a critical question. The statute applies to employment agreements and some other agreements affecting employees; but it normally does not apply to non-competition clauses incident to the sale of a business. Courts are very exacting in reviewing agreements under Section 103.465, and cannot reform or partially enforce agreements that are overbroad in any respect. In the case of agreements incident to the sale of a business, courts have much more latitude to enforce an agreement, or enforce it in part. There is little clear authority, however, in determining which rules apply. Companies buying or selling businesses often want much more protection against competition than Section 103.465 permits. If the agreements they enter into are treated by a court as employment agreements subject to Section 103.465 (instead of agreements incident to the sale of a business), then the buyer may end up getting nothing. Thus, the stakes are high in determining whether Section 103.465 applies to a particular agreement. *Selmer* is one of very few published Wisconsin cases addressing this important question; so whatever guidance *Selmer* provides is very valuable.

The *Selmer* court reasoned that the public policy behind Section 103.465, namely to protect employees from unreasonable trade restraints, was inapplicable, even though Rinn was an employee at the time he entered into the agreement, because there were no consequences attached to Rinn's refusal to accept the agreement. In other words, Rinn could have refused the agreement and his employment would not have been affected in any way. Rinn was free to walk away from the deal, but instead he freely chose to enter into the agreement in exchange for the opportunity to purchase an ownership interest in Selmer's parent company.

The court found, based on the context and the totality of the circumstances in which the agreement arose, that Selmer had no bargaining advantage over Rinn and, as a result, the covenant was part of a bargained-for exchange, which could be separated from the employment relationship.

There are two key aspects to the Court of Appeals decision. First, the Court of Appeals found it important that employment was not contingent on signing the agreement. This is not typically an important consideration in sale of business contexts. Often, in fact, documents executed in connection with a bona fide sale of business include employment contracts for executives as part of the transaction. *Selmer* may create drafting and negotiating issues for such "stay-on" employment agreements.

Second, Rinn was apparently a fairly minor shareholder of Selmer Company. The decision does not state his percentage; but he paid $3,287.76 for his share options. One of the open questions in Wisconsin is when the sale of business rules apply to transactions involving minority shareholders. How small can a shareholder's percentage of total equity be and still have a court apply the sale of business rules to a non-competition agreement? Other states have addressed this question; but Wisconsin has very little guidance. *Selmer* provides a *little more* guidance. There is no bright line test; but Rinn's equity percentage was not so small as to even merit mention by the court.

Rinn argued that employers will evade Section 103.465 by having employees each receive one share of stock. The Court of Appeals brushed this argument aside, noting that courts look to "the totality of the circumstances" in evaluating non-competition agreements, and re-emphasizing that Rinn's employment wasn't conditioned on receiving the stock options. Implicit in the Court of Appeals' reasoning is that if a stock transfer is really a sham to avoid Section 103.465, courts are able to see through the sham and invalidate an agreement.

Having decided that Section 103.465 did not apply, the court instead applied the less stringent common law "rule of reason," and found that the covenant not to compete was reasonably necessary for the protection of the employer, reasonable between the parties (particularly as to the party restrained, considering time, space, purpose, and scope), and not specially injurious to the public. Therefore, the court held that the covenant not to compete was enforceable and awarded the company over $73,000 in damages against Rinn.

The take-away from *Selmer* is that the law regarding when and whether the sale of business rules apply in a particular context remains less than fully developed in Wisconsin. The *Selmer* case helps in some respects, but creates a problem in suggesting that conditioning employment on executing an agreement is an important factor. Buyers and sellers of businesses should be aware of this distinction, especially in negotiating "stay-on" agreements for owners or employees of the seller.

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