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LEGAL ALERT

Legal Alert: Texas Supreme Court Expands Enforceability of Covenants not to Compete

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Executive Summary: The Texas Supreme Court delivered its eagerly anticipated opinion in *Marsh USA, Inc. v. Cook* on June 24, 2011. The issue in *Marsh*: whether the employee's exercise of stock options could constitute an interest sufficient to support his agreement not to compete. The Court held that it did, sparking new debate among practitioners about the extent to which employers may essentially buy employees' agreement to covenant not to compete.

To understand the greater implications of *Marsh*, it is important to place it in historical context.

The History of Covenants not to Compete in Texas

The background of non-competition law in Texas begins with the Texas Business & Commerce Code, which in pertinent part states that covenants not to compete are enforceable if: (1) the covenant is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made, and (2) the agreement contains limitations as to time, geographic area, and scope of activity to be restrained that are reasonable and do not impose greater restraint than necessary to protect goodwill or other business interests of the company. Tex.Bus.Comm.Code § 15.50.

The Texas Supreme Court first analyzed this "ancillary to or part of an otherwise enforceable agreement" in *Light v. Centel Cellular*, 883 S.W.2d 642, 647 (Tex. 1994). There, the court held that for the agreement to be enforceable, the consideration that the employer gives in exchange for the agreement not to compete *must give rise to the employer's interest in restraining the employee*.

Light was also restrictive in that the "otherwise enforceable agreement" was held to mean that a unilateral contract could not support a covenant not to compete. In other words, the covenant not to compete had to be supported by the employer's immediate provision of confidential information and/or training to the employee; the promise to provide such information or training at a later date was illusory (because of the nature of at-will employment) and was not an otherwise enforceable agreement.

In *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644, 651 (Tex. 2006), the Texas Supreme Court retreated from this restrictive interpretation of the timing issue, holding that an agreement could become

enforceable whenever the employer performed the promise that was illusory at the time the employee agreed not to compete. The result eliminated the requirement that an employer had to hand over confidential information and/or training at the exact moment the employee agreed not to compete.

The Texas Supreme Court retreated even further from *Light* in *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding*, 289 S.W.3d 844 (Tex. 2009). There, the employee's non-compete failed to state that the employee would be given access to confidential information. Although not explicitly stated in his non-compete, the court held the employee's position as an accountant mandated that he have access to his employer's confidential information to perform his job. The court found the promise to provide such confidential information was implied.

Both *Sheshunoff* and *Mann Frankfort* liberalized *Light's* strictures regarding the timing of the exchange of consideration for the covenant not to compete, and eliminated "magic words" as a barrier to enforceability. For the first time, in *Marsh*, the Court examined the character of the consideration.

The Majority Opinion of Marsh

The employer, Marsh, offered the employee, Cook, stock options in exchange for signing non-solicitation and non-competition agreements. The agreements provided that if Cook left the company within three years of exercising the stock options, he could not compete in the same business or solicit Marsh's employees for a period of two years.

Cook signed the agreement, subsequently exercised the stock options, and then resigned from Marsh within three years of that exercise. Marsh sued Cook for breach of contract after Cook began employment with Marsh's direct competitor.

Cook argued that the covenant not to compete was not ancillary to an enforceable agreement because Marsh's offer of stock options did not give rise to its interest in restraining Cook from competing. The court of appeals agreed, holding:

[T]he fact that a company's business goodwill benefits when an employee accepts the offered incentive and continues his employment does not mean that the incentive gives rise to an employer's interest in restraining the employee from competing. *Marsh USA Inc. v. Cook*, 287 S.W.3d 378, 381-82 (Tex. App.—Dallas 2009, pet. granted).

The Texas Supreme Court, in its analyses, took a different view of *Light's* requirement that the consideration given to the employee "give rise to" the employer's interest in restraining the employee. The court focused on the statutory language, which does not contain the "give rise to" language, and found that there must only be an otherwise enforceable agreement. There is no mandate, outside of *Light*, that the consideration give rise to the interest in restraining the employee from competing.

Instead, the court focused on "interests worthy of protection"; such interests include trade secrets, confidential information, and goodwill. The offer of stock options to key employees gave rise, in the court's view, to a protectable interest in goodwill because of the company's interest in attracting and retaining talented employees, such as Cook, who fostered

important relationships with Marsh's valued customers.

The Concurrence, Dissent and Response

Five justices joined in the opinion of the court; one justice concurred in the judgment only; and three justices dissented.

In his concurrence, Justice Willett joined in the judgment of the court with the additional warning against allowing employers to simply say "magic words" – like goodwill – to "camouflage a less noble interest: escaping future competition from [the employee]."

Justice Green's dissent noted the court's holding was in direct contravention of the earlier holding in *Light*, which required the consideration to give rise to an interest in restraining trade, instead of just any general business interest. In questioning this abandonment of *Light*, the dissent noted the Texas Legislature has revised the Non-Compete Act three times since *Light* was decided, yet it never addressed the portion of that opinion requiring the consideration to give rise to an interest in restraining trade.

Of most interest, the dissent sounded the alarm that, post-*Marsh*, virtually any kind of financial compensation could give rise to an enforceable restraint of trade, despite Texas courts' historical consensus to the contrary. Justice Green questioned how stock options are distinguishable from any other financial incentive, and how stock options could give rise to goodwill more than any other financial incentives. In other words, the dissent believed the court's opinion effectively now allows employers to simply buy their employees' non-compete agreements.

Employers' Bottom Line

The *Marsh* opinion arguably widens the scope of consideration that could support an enforceable agreement. Previously employers have had difficulty proving the existence of trade secrets or confidential information to which employees had access in order to show consideration to support the agreement not to compete. Now, employers can be more creative in what benefits they can bestow on employees to arguably constitute consideration.

If you have any questions regarding this decision or other labor or employment related issues, please contact the authors of this Alert, MattScott, mscott@fordharrison.com or Allyn Lowell, alowell@fordharrison.com, attorneys in our Dallas office, or the Ford & Harrison attorney with whom you usually work.