ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

in this issue:

OCTOBER 2006

The Texas Supreme Court has clarified the test for noncompete contracts with at-will employees. In *Sheshunoff Management Services, L.P. v. Johnson,* the Court eliminates the onerous requirement for an instantly enforceable agreement applied by some lower courts and shifts the focus back to the reasonableness of the restrictions used in the contract. However, some special requirements for noncompete contracts will still apply under Texas law.

Texas Edition

A Littler Mendelson Texas-specific Newsletter

Texas Supreme Court Provides New Focus for Noncompete Contract Enforcement

By M. Scott McDonald, Timothy T. McInturf, and Kimberly R. Miers

All employers have good reason to welcome the Texas Supreme Court's most recent ruling on noncompete contracts. Much of the confusion that made noncompete contract enforcement in Texas difficult to predict has been eliminated. In *Alex Sheshunoff Management Services, L.P. v. Johnson*, the Texas Supreme Court shifts the focus for noncompete contract analysis away from technical timing and contract formation issues that dominated recent decisions, and back to whether the contract is reasonable and necessary for the protection of a legitimate business interest. Lower courts were split on whether the Texas Covenant Not to Compete Act (the "Act") required a specific formation process with unique timing requirements. It is now clear that the contract formation *process* will be less important than the *content* of the contract and circumstances surrounding *performance* of it.

The Problem with the Status Quo

Lower court opinions were mixed on what elements an enforceable noncompete contract needed to have under the Act. This often resulted in the application of harsh, all-or-nothing tests. Much of this confusion was caused by the Texas Supreme Court's footnote-heavy, 1994 decision in *Light v. Centel Cellular Co.* (a complicated opinion that was fodder for many humorous article titles like "*The Incredible Darkness of Light*"). A number of courts interpreting *Light* concluded that it required the presence of an instantly enforceable contractual promise by the employer to provide confidential information, customer goodwill, or some similar item justifying a noncompete restriction at the time the noncompete contract was made. This was a very impractical and difficult test for employers to comply with in the at-will employment context because most employment relationships involve the gradual accumulation and sharing of confidential information and customer relationships over time. The result was uncertainty for everyone - both employers who wanted to use the contracts to protect their company, and employers who did not use them but wanted to hire employees from employers that did. The confusion was also unfair to employees who often got mixed messages about the enforceability of noncompete agreements in Texas.

Factual Background

In *Alex Sheshunoff Management Services, L.P. v. Johnson*, the employer, Alex Sheshunoff Management Services, L.P. ("ASM"), hired Kenneth Johnson ("Johnson") to work as a consultant to financial institutions. Five years later, ASM promoted Johnson to a Director position that required him to cultivate client relationships. In connection with Johnson's promotion, ASM required him to sign an employment agreement that included a noncompete clause. The contract was like an at-will relationship because ASM retained the right to terminate his employment without cause at any time. The restrictive covenant stated that Johnson would not provide or assist in providing consulting services to ASM's clients and prospective clients for a period of one year. In return, ASM promised to provide Johnson with special training and access to ASM's confidential information, which Johnson later received.

Approximately five years after signing the employment agreement, Johnson voluntarily

terminated his employment with ASM and accepted a position with a competing company—Strunk & Associates, L.P. ("Strunk"). ASM filed a suit against Johnson and Strunk for breach of a covenant not to compete, requesting injunctive and monetary relief. After the trial court granted a temporary injunction, Johnson and Strunk filed a motion for summary judgment claiming that the noncompete was unenforceable as a matter of law. In granting summary judgment, the trial court relied on language in the Act, which states that a "covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement *at the time the agreement is made* ..." The trial court concluded that ASM's promises to provide training and confidential information were illusory at the moment the agreement was made because ASM could have terminated the relationship before providing any confidential information or training. The Austin Court of Appeals agreed with this reasoning, as had a number of other courts of appeal around the state.

Before the Texas Supreme Court, both parties argued that the Court's prior decision in *Light v. Centel Cellular Co.* controlled, but each gave it different meaning. ASM contended that under footnote 14 of *Light*, the statute's requirement for an enforceable ancillary agreement was satisfied because Johnson's contract contained a promise to provide future access to confidential information and to provide training. ASM further argued that continued access to confidential information was provided immediately and was a thing of value in and of itself, regardless of whether new confidential information was immediately provided. Johnson, relying on footnote 6 in *Light*, countered that the promises made by ASM in the contract were terminable at-will, illusory and thus insufficient to support a noncompete contract. Amicus briefing submitted in the case argued that the Supreme Court should take a more dramatic step, depart from the contract-formation oriented focus of the footnotes in *Light*, and shift the focus back to the original intent of the statute - a focus on the reasonableness and necessity for the restrictions at issue. The Texas Supreme Court sided with ASM and found that the Act's ancillary agreement requirement was met but also went further by electing to depart from *Light* and focus on the intent of the statute.

The Statute's Intent

In adopting and later amending the Texas Covenant Not to Compete Act, the Legislature actually intended to make covenants not to compete easier—rather than harder—to enforce. In *Alex Sheshunoff*, the Texas Supreme Court clearly recognizes and acknowledges this purpose behind the statute. The Court explains that the holding in *Light* should be interpreted narrowly and not in a way that defeats the overall intent of the statute.

The Court looked closely at the meaning of the Act's clause "at the time the agreement is made," and decided to reject the reasoning of footnote 6 in the *Light* opinion. Footnote 6 of *Light* indicated that this clause meant that the employer's contract promise must be immediately enforceable and not dependent upon continued at-will employment for performance. After analyzing prior versions of the statute, House and Senate bill analyses and proposed amendments, the Court determined that the Legislature's intent was to ensure that "mid-stream" covenants were supported by new consideration, not to require immediately enforceable obligations on the part of the employer. The Court concluded that a contrary interpretation would make it nearly impossible to create an enforceable noncompete in the at-will employment context, which would undermine the intent of the Act and the 1993 amendments to it. The Court expressly held that executory contracts—contracts that can be accepted by future performance—are sufficient. This is a key clarification in the law.

The End Result

The New Test. Under the Court's new holding, a covenant not to compete that meets the reasonableness requirements set forth in the statute "becomes enforceable when the employer performs the promises it made in exchange for the covenant." Thus, noncompete contracts with at-will employees and noncompete contracts that are entered into after employment begins will be easier to enforce. The key inquiries will now be: (a) what contractual promises did the employer make, (b) did the employer fulfill these contractual promises, and (c) do these promises and return obligations of the employee justify the noncompete restriction used. An example can be seen in *Alex Sheshunoff* itself. The Court held that Johnson's covenant not to compete was enforceable because ASM provided confidential information and specialized training as promised and Johnson promised not to disclose ASM's confidential information in return.

A Reasonableness Focus. "Reasonableness" evaluations will now be a point of increased focus, but this is less likely to create "all-or-nothing" decisions. The Act provides that courts "shall" reform overbroad agreements to make them enforceable. Consequently, in many cases some degree of enforcement through injunctive relief is likely to occur even if the contract is overbroad as written. However, employers should not take this development as a free pass to use overbroad agreements. The reformation provisions in the Act have counter-balancing elements. When a noncompete contract is found to be overbroad, (a) the employer will not be allowed to recover damages for any violation that occurs prior to reformation of the contract by the court, and (b) the employer may also have to pay the former employee's attorneys' fees and costs under some circumstances.

Technical Requirements Still Exist

The Court's decision brings Texas law more in line with the majority of other states, but it also retains some elements unique to Texas. Employers must still pay careful attention to the structure of noncompete agreements used in Texas. It is likely that only certain contractual promises *from both parties* will be sufficient. The Court's holding does not eliminate the need for an enforceable contract that gives rise to (or justifies) the need for the noncompete agreement. The promises that form the consideration for the agreement must be related to a legitimate interest that justifies a noncompete contract, like the protection of confidential information, customer goodwill, or specialized training.

Back to the Basics

The Court's opinion reminds employers that covenants not to compete are only enforceable to the extent necessary to protect the legitimate business concerns of employers. Rejecting the recent trend by courts to place great empha-

sis on "overly technical disputes," the Court made clear that the core inquiry should be on the reasonableness of the length of time, geographical scope and activity to be restrained set forth in the covenant not to compete. The Court deliberately shifted the focus of noncompete analysis to whether the covenant imposes a greater restraint than is necessary to protect the legitimate business interests of the employer.

Sheshunoff Management Services, L.P. v. Johnson is an Important Case to Employers Because it:

- Makes noncompete contracts easier to use in Texas.
- Eliminates technical hurdles to the use of noncompete contracts with at-will employees and incumbent employees.
- Increases the focus on the ***justification for*** and ***reasonableness of*** the restrictions.
- Eliminates much of the confusion caused by the Texas Supreme Court's *Light* decision.
- Requires hiring employers to be more cautious about hiring from competitors who use noncompete contracts in Texas.
- Increases the likelihood of litigation over noncompete contracts.
- Means employers who use or would like to use noncompete contracts should have their contracts reviewed for compliance with the new standard set by the decision.

M. Scott McDonald is a Shareholder in Littler Mendelson's Dallas office. Timothy T. McInturf is a Shareholder in Littler's Houston office. Kimberly R. Miers is an Associate in Littler's Dallas office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Mr. McDonald at smcdonald@littler.com, Mr. McInturf at tmcinturf@littler.com, or Ms. Miers at kmiers@littler.com.