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The Texas Supreme Court has further departed from its prior technical and impractical interpretation of the state Covenant Not to Compete Act, ruling that a stock options award to a valuable employee provides the necessary "nexus" to protection of a company's goodwill.

The Door Continues to Close on Light: Texas Supreme Court Holds Stock Options Award to Valuable Employee Provides Necessary "Nexus" to Protection of Company's Goodwill

By Scott McDonald, Jacqueline Johnson Lichty and Allan H. Neighbors

In 2006 and again in 2009, the Texas Supreme Court significantly departed from its 1994 decision in *Light v. Centel Cellular Co*., a case that confounded employers, practitioners, and courts for years with its highly technical and largely impractical interpretations of the Texas Covenant Not to Compete Act (TEX. BUS. & COM. CODE § 15.50 *et seq*.) ("the Act"). On June 24, 2011, the Texas Supreme Court further departed from *Light* by doing away with the requirement that consideration for a covenant not to compete must "give rise" to the employer's interest in restraining the employee from competing. In doing so, the court ruled by a 6-3 majority that stock options granted to a valuable employee are sufficient consideration to support a post-employment restrictive covenant because they are "reasonably related" to the company's interest in protecting its goodwill. As it did in 2006, the court sent a strong signal to lower courts that the focus is whether or not the *covenant* is reasonable, not whether the *agreement* passes muster under a highly technical analysis not contemplated by the Texas Legislature.

Factual Background

Rex Cook began his employment with Marsh USA Inc. in 1983, ultimately rising to become a managing director. The company considered Cook a valuable employee who had performed successfully in his position. While employed, the employee developed a track record of successfully attracting and retaining insurance brokerage business. According to the company, "long term personal contact between the employee and customer is especially important due to similarity in the product offered by competitors." The company also believed the "advantage acquired through the employee's long-term relationship and contact with customers is part of [Marsh's] goodwill." For those reasons, the employee was granted the option to purchase shares of Marsh's parent company's common stock at a reduced strike price in 1996 pursuant to a stock award program, which was, according to the company, developed to provide "valuable," "select" employees with the opportunity to become part owners of the company.

In February 2005, the employee notified the company that he wanted to exercise his right to acquire 3000 shares of the common stock at the strike price. In order to do

so, the employee was required, among other things, to sign an agreement that contained his promise not to disclose the company's confidential information and trade secrets during and after his employment and to refrain from certain competitive activities for a two-year period *if* he left the company within three years of exercising the options. The employee signed the agreement and exercised the stock, but resigned less than three years after doing so and immediately began employment with one of the company's direct competitors.

The company immediately sued the employee and his new employer, claiming, among other things, that the employee had solicited and accepted business from clients and prospective clients of the company who were serviced by the employee during his employment with the company, in violation of the agreement he signed in connection with his exercise of the stock options. The trial and appellate courts in Dallas denied the company's claims for breach of contract, holding that the transfer of stock did not "give rise" to the company's interest in restraining the employee from competing. As discussed below, the Texas Supreme Court reversed the lower courts' decisions.

The Court's Analysis and Holding

In *Marsh*, the Texas Supreme Court takes yet another aggressive step towards eliminating technical "all or nothing" arguments against the enforcement of covenants not to compete in Texas. The overriding theme of this opinion echoes that of the court's 2006 opinion in *Alex Sheshunoff Management Services, L.P. v. Johnson*: technical arguments over the meaning of the portion of the Covenant Not to Compete Act that requires the restrictive covenant at issue to be ancillary to or part of an otherwise enforceable agreement will no longer rule the day. Instead, the court goes back to its basic theme from the *Sheshunoff* decision that the first step in the two-step statutory construction is there to avoid naked, stand-alone noncompete obligations, and not to serve some other more complicated and convoluted construction obligation.

The court's decision ends a line of reasoning about the meaning of the phrase "ancillary to" that originated in *Light*. In *Light*, "ancillary" was used to justify a test whereby the consideration provided the employee in the otherwise enforceable agreement must "give rise" to "the employer's interest in restraining the employee from competing." In *Marsh*, the court rejects this test, and provides the following reasoning:

> . . . the Legislature did not include a requirement in the Act that the *consideration* for the noncompete must give rise *to the interest in restraining competition with the employer*. Instead, the Legislature required a nexus—that the noncompete be "ancillary to" or "part of" the otherwise enforceable agreement between the parties. Tex. Bus. & Com. Code §15.50(a). There is nothing in the statute indicating that "ancillary" or "part" should mean anything other than their common definitions. "[A]ncillary means 'supplementary' and part means 'one of several . . . units of which something is composed.'" [citations omitted]

Thus, the Texas Supreme Court has articulated a new test for the first prong of the two-step analysis. Notably, however, the court has not completely abandoned the requirement that the consideration have some reasonable relationship to an otherwise protectable interest. To support this "nexus" requirement, the court refers to the common law test that existed prior to 1987:

> . . . the covenant not to compete must be ancillary to (supplementary) or part of (one of several units of which something is composed) an otherwise enforceable agreement. . . . This interpretation is confirmed by the pre-existing common law requirement that the otherwise enforceable agreement must be reasonably related to the interest worthy of protection. . . . *Consideration for a noncompete that is reasonably related to an interest worthy of protection, such as trade secrets, confidential information or goodwill, satisfies the statutory nexus*; and there is no textual basis for excluding the protection of much of goodwill from the business interests that a noncompete may protect.

The italicized language indicates that there is still need for some connection between the consideration given by the employer and an interest worthy of protection. So, is the "give rise" test truly dead? Only time will tell, but it would appear that it has been modified to be a much looser requirement for some kind of reasonable relationship between a protectable interest and the consideration given. In *Marsh*, that reasonable relationship was present, at least in part, in the goodwill connection between Marsh's interest in the restraint and the stock options awarded to Cook.

In *Marsh*, the Texas Supreme Court also provided some useful guidance on the meaning of the often misunderstood concept of "goodwill." The court explained that a company's goodwill is essentially:

> . . . the relationships the company has developed with its customers and employees and their identities, due in part to [the employee's] performance as a valued employee. The Act provides that "goodwill" is a protectable interest. [citations omitted] Texas law has long recognized that goodwill, although intangible, is property and is an integral part of the business just as its physical assets are. [citations omitted] Goodwill is defined as: "the advantage or benefits which is acquired by an establishment beyond the mere value of the capital stock, funds or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant and habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices."

The court then goes on to explain that while there is a reasonable nexus between a protectable interest (goodwill) and the ancillary agreement at issue, the court is expressly declining to ". . . decide whether the Agreement is reasonable as to time, scope of activity, and geographical area." The court simply points out that if, on remand, the trial court determines that any particular provision is unreasonable or overbroad, the trial court has the authority to reform the agreement and enforce it by injunction with reasonable limitations.

Interestingly, in the course of discussing what type of restrictions would fall within the Act's requirements and which would not, the court may have unwittingly opined on something that was not really at issue in the case – namely, the applicability of the Act to *employee* nonsolicitation clauses. The court states that "Covenants that place limits on former employees' professional mobility or restrict their solicitation of the former employers' customers *and employees* are restraints on trade and are governed by the Act." (emphasis added) In so doing, the court lumps together solicitation of customers and employees as if they were equally subject to coverage under the Act. The court then distinguishes other types of restrictive clauses like nondisclosure and confidentiality obligations. The court also lumps together the company's relationship with "its customers and employees" when discussing the definition of goodwill. However, it should be noted that there is no real substantive analysis of the potential distinctions between employee nonsolicitation and customer nonsolicitation clauses in the opinion. A key sentence in the opinion notes that "[t]he parties concur that the Agreement in this case is governed by the Act." Thus, it appears the court viewed the scope of coverage issue as an uncontested matter. And there is no indication that a distinction between customer nonsolicitation and employee nonsolicitation clauses was argued or at issue. Thus, the association of employee nonsolicitation and customer nonsolicitation together might be construed as dicta.

The court also addressed a timing argument regarding the existence of a protectable interest. The argument was that if the protectable interest at issue was already in play due to some prior consideration or benefit provided to the employee before the noncompete contract was entered into, then the new consideration provided in the noncompete agreement would not meet the requirements of the statute. The court rejected this argument, stating: "[t]here is no requirement under Texas law that the employee receive consideration for the noncompete agreement prior to the time the employer's interest in protecting its goodwill arises." But the court's opinion was also not particularly clear on how it resolved this issue and instead it simply set the argument aside as irrelevant by comparing the continuing nature of goodwill with the continuing nature of a flow of confidential information. The court may have accepted the idea that goodwill would simply be too hard to parse into "before and after" increments of time, but it did not really address what might occur if the factual record on timing were clearer.

Open Questions

Although the Texas Supreme Court's decision in *Marsh* should be viewed as a further breath of fresh air for employers seeking to rely on noncompete agreements in Texas, several questions are raised by the court's opinion.

Employee Non-Solicitations: As noted above, the majority opinion lumps together employee non-solicitation covenants, which have not previously been analyzed under the Act, and customer non-solicitation agreements, which have always been required to meet the Act's limitations. So, did the majority intend to issue a sweeping change in the law, or was it inadvertent? Only time will tell.

Reasonable Relationship / Nexus Test: How broad or narrow will the required nexus (reasonable relationship) between an item of consideration and a legitimate protectable interest turn out to be? Clearly the court affirms the standard litany of confidential information and trade secrets, specialized training, and goodwill as protectable interests. And the court illuminates the scope of what can be swept into the coverage of protecting "goodwill." But what other "reasonable relationship" to one of these protected interests might be argued

for, beyond the "stock to goodwill" link approved here; what other kinds of benefits of employment (financial or not) might trigger such a relationship argument?

Other Financial Benefits: In *Marsh*, the financial benefit at issue was stock options. As the dissenting justices to *Marsh* point out, the majority opinion leaves unclear what other forms of financial benefit will be viewed as sufficient consideration to support a post-employment restrictive covenant in the name of protecting goodwill. The majority does not directly address this question, but it does explain in some detail that stock options are designed to further goodwill because they give the employee a greater stake in the company's future performance, thereby aligning the employee's long-term interests with those of the company. So, could other financial benefits meet this same analysis? To be sure, the next few years will see employers making this argument in Texas.

Reasonableness Test: As the majority again made clear in *Marsh*, the lower courts' analysis should be focused on whether or not the purported restrictive covenant is reasonable in terms of time, scope of activity, and geographical area. Historically, that analysis has focused, in large part, on the nature of the confidential information, trade secrets, or specialized training that the employee received from the company and his or her job duties for the company. If financial benefits such as stock options are now considered adequate consideration for a post-employment restrictive covenant, how will the courts determine whether the covenant is reasonable in terms of time and geography, for example? As has always been the case in the context of the rendering of personal services, the burden will remain on the employer to make this showing.

The Second Prong of Light: The second prong of *Light* requires that when evaluating the reasonableness of the restriction, the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement. The *Marsh* court noted, in footnote 7, that the second-prong of *Light* was not at issue in the case. However, the court went on to state: "we re-emphasize that the Act provides for the enforcement of *reasonable* covenants not to compete" (emphasis in original) Therefore, it is unclear whether, and to what degree, the "designed to enforce" standard for evaluating reasonableness in the second-prong of *Light* continues in effect or might apply now. Again, only time will tell.

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