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Texas Supreme Court Upholds Enforceability of Covenants Not to Compete

By **Matt Dow**, **W. Gary Fowler**, and **Scott McLaughlin**

For years, the conventional wisdom was that covenants not to compete in Texas were unenforceable. While never literally true, the difficulty in enforcement was highlighted by a series of Texas Supreme Court decisions between 1987 and 1994, starting with *Hill v. Mobile Auto Trim Inc.*, 725 S.W.2d 168, 170-171 (Tex. 1987), and culminating in *Light v. Centel Cellular Co. of Texas*, 883 S.W.2d 642 (Tex. 1994).

Then after twelve years of silence on the issue, the Supreme Court of Texas waded into the murky waters of *Light* and introduced a new era of Texas judicial interpretation of non-competition covenants. In *Alex Sheshunoff Management Services, L.P. v. Johnson*, 209 S.W.3d 644 (Tex. 2006), the Court moved away from the highly technical analysis of non-competition agreements that had been emphasized in *Light* and restored the focus of enforcement upon the reasonableness of an agreement's restrictions. This trend continued in several decisions that followed *Sheshunoff*, culminating with last Friday's decision in *Marsh USA v. Cook*, No. 09-0558 (Tex. June 24, 2011).

In *Marsh*, Rex Cook joined Marsh in 1983 and eventually was promoted to managing director. In 1996, Marsh granted Cook the option to purchase 500 shares of Marsh stock under an Incentive and Stock Award Plan. The Plan was developed to provide "valuable," "select" employees with the opportunity to become part owners of the company with the incentive to contribute to and benefit from the long-term growth and profitability of Marsh. To exercise the option, Cook was required to sign a nonsolicitation agreement (Agreement), which he did. The Agreement provided that if he left Marsh within three years after exercising the options, then for a period of two years after termination Cook would not: (1) solicit or accept business of the type offered by Marsh during Cook's employment and (2) solicit any employee of Marsh who reported to Cook directly or indirectly to terminate his employment with Marsh for the purpose of competing with Marsh.

Within three years after signing the Agreement and exercising the options, Cook resigned from Marsh and immediately began employment with a direct competitor of Marsh's. The lawsuit was then filed by Marsh. The trial court granted Cook's motion for partial summary judgment on the breach of contract claim, concluding that the Agreement was unenforceable as a matter of law. Marsh non-suited its other claims and appealed the partial summary judgment. The Dallas Court of Appeals affirmed the trial court's decision, holding that the transfer of stock did not give rise to Marsh's interest in restraining Cook from competing. The decision of the Dallas Court of Appeals rested on earlier opinions by other courts interpreting Texas law that a stock option could not "buy" a

covenant not to compete. *See, e.g., Olander v. Compass Bank*, 363 F.3d 560, 565 (5th Cir. 2004).

The Texas Supreme Court ruled that the Agreement was "ancillary to or part of" an otherwise enforceable agreement because the business interest Marsh sought to protect - goodwill - was reasonably related to the consideration given: Cook's stock options. The Court rejected the stricter standard in *Light* that the consideration itself must give rise to the employer's interest in restraining competition. The Court also confirmed that "[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." The case was then sent back to the trial court so that that court could decide whether the restrictions in the Agreement as to scope, time and geography were reasonable.

The Texas Supreme Court in the *Marsh* decision has signaled clearly that it intends to find covenants not to compete enforceable unless the covenant is overly broad as to time, geography and scope of activity.

So, what are the practical implications?

The form of the covenant has less importance than it did before *Sheshunoff* and *Marsh*. The Court emphasized in *Marsh*, as it had in *Sheshunoff*, that "overly technical disputes" should not govern the enforceability of a covenant not to compete. Instead, the pivotal question has now become whether the covenant not to compete is necessary to protect a legitimate interest of the employer—such as confidential information, specialized training or goodwill—and whether the covenant is reasonable in doing so as to its restrictions in time, geography and scope of activity.

The second practical implication was emphasized by the dissent: it may now be too easy to enforce a covenant not to compete. If a covenant can be "bought" by stock options, then it may soon be possible to argue that a bonus, a raise, a promotion or any sort of consideration will support a covenant not to compete.

Undoubtedly, for now, the pendulum has swung in favor of the enforceability of covenants not to compete in Texas. However, the Court's decision was not unanimous but a 6-3 decision. And, more importantly, Justice Willet concurred in the Court's decision only and not its opinion. In his separate opinion, Justice Willet goes to great lengths to extol the virtues of "robust competition" and to emphasize that "going too far to protect what may be protectable - is *verboten*."

So employers should still be wary about using noncompetes. In using these, employers should consider this question: "What are we trying to protect, and have we gone to far in trying to protect it?"

If you have any questions regarding this e-Alert, please contact any one of the following e-Alert authors:

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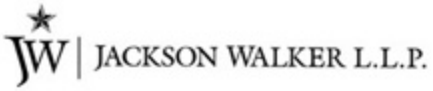

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