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Tracking Noncompete Enforcement In Texas

Law360, New York (July 6, 2011) -- On June 24, 2011, The Texas Supreme Court issued its long-awaited decision in Marsh USA Inc. and Marsh & McLennan Cos. v. Rex Cook regarding the standards for enforcement of noncompete agreements under the Texas Business and Commerce Code. In upholding noncompete covenants that were part of a stock option agreement, the court at least partially overruled previous Texas Supreme Court authority.

As a practical matter, Cook should make noncompete agreements significantly easier to enforce in Texas. Perhaps more importantly, the case changes the way the likelihood of enforcement of noncompete agreements is assessed and brings Texas law more in line with the laws of other states that focus on the overall reasonableness and legitimacy of the employer's business interests.

Noncompete agreements, which include prohibitions on working for a competitor and limitations on an employee's ability to solicit customers, are governed in Texas by sections 15.50 through 15.52 of the Texas Business and Commerce Code. Under the Code, which was amended by the Texas legislature in 1989, such agreements may be enforced only if they contain reasonable limitations with respect to geography, time and scope of activity to be prohibited and only if they are "ancillary to or part of an otherwise enforceable agreement."

Texas courts, as well as practitioners and employers, have struggled with this latter requirement. The Cook case represents a significant change in Texas law and a departure from the Texas Supreme Court's previous analysis of noncompete agreements.

In Light v. Centel Cellular Co. of Texas, 883 S.W.2d 643 (Tex. 1994), the Texas Supreme Court first construed the amended language of the Business and Commerce Code. Light held that the "otherwise enforceable agreement" language in the Code means that a noncompete agreement, like any contract, must be supported by consideration and that the offer of at-will employment, because it may be terminated at any time by the employer, does not by itself constitute an enforceable promise.

The court in Light further held that the "ancillary" language in the Code means that there must be some nexus between the parties' promises such that the employer's promise must "give rise to" its interest in limiting competition in the market. After Light, the paradigm example of an enforceable noncompete agreement was an employer's promise to provide an employee with confidential information in

exchange for the employee's promise not to compete with his employer or solicit its customers.

In the wake of Light, practitioners generally would assess enforcement of a noncompete agreement by, (1) scouring the agreement to identify a contractual promise beyond at-will employment and (2) assessing whether that promise created an interest on the employer's part in restraining competition. Nonetheless, Light left open several critical issues.

For example, how express must the employer's consideration, such as a promise to provide confidential information, be spelled out in the agreement? Did Light require employers to provide consideration simultaneous to the employee's execution of a noncompete agreement, or was it sufficient that the consideration be provided over time during the course of the employment relationship? How did the Light test account for employer goodwill, which is identified in the Business and Commerce Code as a protectable employer interest, but cannot be "given" to an employee in the same sense as specialized training or confidential information? Were there other kinds of employer consideration that, like specialized training and confidential information, might "give rise to" an interest in restraining competition?

Some, but not all, of these questions were answered in a series of cases decided after Light. In Alex Sheshunoff Mgmt. Servs. LP v. Johnson, 209 S.W.2d 644 (Tex. 2006), the Texas Supreme Court reached the fairly unremarkable conclusion that a simultaneous exchange of consideration was not required by Light and that a noncompete agreement could be upheld if the employer provided confidential information to the employee over time. This result was fairly predictable — How can specialized training, the consideration partially at issue in Light, be provided simultaneous to an employee's execution of a contract?

More significant was the Texas Supreme Court's decision in Mann Frankfort Stein & Lipp Advisors Inc. v. Fielding, 289 S.W.3d 844 (Tex. 2009), which held that an implied promise to provide confidential information, which could be inferred from an employee's nondisclosure promises, was enough to satisfy the Light test. This meant that enforcement could no longer be assessed simply by reviewing the text of an agreement to identify a contractual promise to provide confidential information or, for that matter, any express promise on the part of the employer.

Cook represents a further and even more significant contraction of the literal holdings of Light and is the first instance where the Texas Supreme Court has expressly criticized the reasoning in Light. In Cook, the Texas Supreme Court considered whether an employer grant of stock options satisfied the "ancillary" prong of the Texas Business and Commerce Code.

Cook joined Marsh in 1983 and signed an agreement under which he could exercise certain stock options in exchange for signing an agreement limiting his ability to solicit or accept business from clients of Marsh with whom he had business dealings during his employment. Cook thus signed the agreement not when he was provided the original grant of stock options, but rather when he chose to exercise the options.

After his separation from employment with Marsh, Cook went to work for a competitor. He thereafter

was sued by Marsh for breach of his contract and for breach of fiduciary duty. Cook filed a motion for summary judgment in the district court on the grounds that the agreement was unenforceable under the Texas Business and Commerce Code. The trial court granted Cook's motion and an appellate court affirmed that ruling.

The Texas Supreme Court, in a six to three opinion, disagreed with the lower courts and reversed the summary judgment grant in favor of Cook.

Significantly, the court overruled previous authority that focused on the type of consideration provided by the employer and the assessment of whether or not that consideration "gives rise" to an interest in restraining competition. Rather, the court construed the Texas Business and Commerce Code as requiring simply that there be a "reasonable nexus" between the noncompete agreement and the employer's interest worthy of protection.

The court viewed the option as creating an ownership interest on Cook's part in the company and found that, by awarding the stock options, "… Marsh linked the interests of a key employee with the Company's long term business interest." The court deemed this linkage to be sufficiently tied to the protection of Marsh's goodwill, and the noncompete was thus enforceable on that basis.

The Cook decision leaves at least some questions open for debate. For example, how critical was Cook's status as a "key" employee to the decision, and does Cook stand for the proposition that noncompete covenants attached to stock option agreements are always enforceable in Texas?

Also unclear is whether other incentive based forms of consideration, such as a bonus or other compensation to be paid if certain sales or other criteria are met, might protect an employer's goodwill in the same manner as the stock options in Cook. Such an incentive bonus would seem to "link the interests of the key employee with the company's long term business interests," just like the stock options in Cook.

While there remain a few open questions, the Texas Supreme Court's decision in Cook clearly continues the trend of noncompete pro-enforcement decisions in Texas. Whether or not the "reasonable nexus" approach makes assessment of enforceability of noncompete agreements easier than Light's more technical approach remains to be seen.

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